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# Insider Trading and the Gradual Demise of Fiduciary Principles

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# Insider Trading and the Gradual Demise of Fiduciary Principles

Donna M. Nagy\*

*ABSTRACT: In United States v. O'Hagan, the Supreme Court established that there are two complementary theories of insider trading liability, each with a fiduciary principle at its core. Under the "classical" theory, liability is premised on a fiduciary's deceptive silence about material nonpublic information in a securities transaction with corporate shareholders. Under the "misappropriation" theory, liability is premised on a fiduciary's deception of the source of the material nonpublic information used in the securities transaction.*

*This Article analyzes the law of insider trading, with a focus on developments since O'Hagan. Based on a comprehensive review of lower-court decisions, settled enforcement proceedings, and rules promulgated by the Securities and Exchange Commission, it argues that notwithstanding the Supreme Court's explicit dictates, fiduciary principles are often not essential to the offense of insider trading. Rather, a host of lower courts and the SEC have in effect concluded that insider trading involves the wrongful use of material nonpublic information, regardless of whether a fiduciary-like duty is breached. Although this conclusion can be justified by the policy objectives underlying O'Hagan, it currently lacks a solid doctrinal foundation. To resolve this anomaly, this Article offers specific suggestions that would bring much needed coherence and legitimacy to the law of insider trading.*

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## I. INTRODUCTION

Just over a decade ago, the U.S. Supreme Court established that there are two complementary theories of insider trading liability, each with a fiduciary principle at its core.<sup>1</sup> Under the “classical” theory developed in *Chiarella v. United States*<sup>2</sup> and reaffirmed three years later in *Dirks v. SEC*,<sup>3</sup> corporate insiders violate Section 10(b) of the Securities Exchange Act of 1934<sup>4</sup> and Rule 10b-5 thereunder<sup>5</sup> when they trade their corporation’s securities while aware of material nonpublic information.<sup>6</sup> An insider’s silence about material facts pertaining to the transaction constitutes deception because “a relationship of trust and confidence [exists] between the shareholders of a corporation and those insiders who have obtained confidential information by reason of their position with that corporation.”<sup>7</sup> Insiders (namely, officers, directors, and employees) who are aware of material nonpublic information are therefore obliged to “disclose or abstain” from trading the securities of their corporation.<sup>8</sup> The obligation to disclose or abstain also extends to temporary agents of the corporations and to persons (so-called tippees) who trade securities based on information shared with them by an insider.<sup>9</sup>

Under the alternative “misappropriation” theory endorsed by the Court in *United States v. O’Hagan*,<sup>10</sup> persons “outside” the issuing corporation can likewise violate Section 10(b) and Rule 10b-5.<sup>11</sup> Such a violation occurs when a fiduciary personally profits from a securities transaction through

1. *United States v. O’Hagan*, 521 U.S. 642, 652 (1997) (“The two theories are complementary, each addressing efforts to capitalize on nonpublic information through the purchase or sale of securities.”).

2. *Chiarella v. United States*, 445 U.S. 222 (1980).

3. *Dirks v. SEC*, 463 U.S. 646 (1983).

4. 15 U.S.C. § 78j(b) (2000). Section 10(b) makes it unlawful for any person, directly or indirectly “[t]o use or employ, in connection with the purchase or sale of any security . . . , any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.” *Id.*

5. 17 C.F.R. § 240.10b-5 (2008). Rule 10b-5 provides that:

It shall be unlawful for any person, directly or indirectly, . . . [t]o employ any device, scheme, or artifice to defraud, . . . or . . . [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

*Id.*

6. *Chiarella*, 445 U.S. at 228.

7. *Id.*

8. *Id.* at 227–28.

9. *Dirks v. SEC*, 463 U.S. 646, 655–61 & n.14 (1983).

10. *United States v. O’Hagan*, 521 U.S. 642 (1997).

11. *Id.* at 652–53.

undisclosed use of a principal's material nonpublic information.<sup>12</sup> Thus, as the Court explained, whereas the classical theory "premis[es] liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned-trader's deception of those who entrusted him with access to confidential information."<sup>13</sup> The *O'Hagan* Court emphasized that the misappropriation theory serves the important policy goals of promoting market integrity and investor confidence because "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."<sup>14</sup> The Court was clear, however, that the circle of outsiders liable under the misappropriation theory was "limited to those who breach[ed] a recognized duty" owed to the information's source.<sup>15</sup>

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12. *Id.* at 651–52.

13. *Id.* at 652.

14. *Id.* at 658. The *O'Hagan* Court's understanding of the policy objectives behind the federal insider trading proscription mirrors views long held by the Securities and Exchange Commission ("SEC"). Indeed, the SEC maintains that "the fundamental unfairness of insider trading harms not only individual investors but also the very foundations of our markets, by undermining investor confidence in the integrity of the markets." Selective Disclosure and Insider Trading, Exchange Act Release No. 43,154, [2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,319, at 83,692 (Aug. 15, 2000) [hereinafter SEC Adopting Release]; see also Joel Seligman, *The Reformulation of Federal Securities Law Concerning Nonpublic Information*, 73 GEO. L.J. 1083, 1115 (1985) (contending that "[t]he primary policy reason for proscribing trading while in possession of material nonpublic information is to make investors confident that they can trade securities without being subject to informational disadvantages"). To be sure, a number of securities scholars have challenged the adequacy of market integrity and investor confidence as a basis for the federal prohibition. See, e.g., JONATHAN R. MACEY, INSIDER TRADING: ECONOMICS, POLITICS, AND POLICY 67 (1991) (arguing that "[t]he regulation of insider trading cannot be justified on the grounds that it promotes the goals of efficiency, fairness, or market integrity" and that attempts to regulate on such grounds "simply reflect efforts by a farrago of special interest groups to obtain private advantage through the regulatory and legislative process"); Stephen M. Bainbridge, *Insider Trading Regulation: The Path Dependent Choice Between Property Rights and Securities Fraud*, 52 SMU L. REV. 1589, 1591 (1999) [hereinafter Bainbridge, *Path Dependent Choice*] (arguing that the "insider trading prohibition ought to be viewed as a means of protecting property rights in information, rather than as a means of preventing securities fraud"); Larry E. Ribstein, *Federalism and Insider Trading*, 6 SUP. CT. ECON. REV. 123, 171 (1998) (arguing that "[m]isappropriation of information is wrong, but we should not make a federal case out of it"). The vast literature on the impact of insider trading is reviewed extensively in 18 DONALD C. LANGEVOORT, INSIDER TRADING REGULATION ENFORCEMENT & PREVENTION §§ 1:2 to 1:6 (2008) [hereinafter LANGEVOORT, INSIDER TRADING] and WILLIAM K.S. WANG & MARC I. STEINBERG, INSIDER TRADING §§ 2:1 to 2:4 (2d ed. 2005). This Article, however, does not rehash these debates. Rather, it highlights the Supreme Court's and the SEC's stated policy objectives and questions whether the Court's fiduciary-based doctrine adequately serves those objectives.

15. *O'Hagan*, 521 U.S. at 666. As discussed more fully in Part II.A, *infra*, the Supreme Court has equated a fiduciary relationship with a "relationship of trust and confidence." See, e.g., *id.* at 653 (noting that the "indictment alleged that O'Hagan" traded Pillsbury stock "in breach of a duty of trust and confidence he owed to his law firm . . . and to its client"); *Chiarella v. United States*, 445 U.S. 222, 228 (1980) (stating that a duty to speak arises out of "a fiduciary or other similar relation of trust and confidence") (quoting RESTATEMENT (SECOND) OF TORTS

Despite the Supreme Court's explicit dictate that fiduciary principles underlie the offense of insider trading, there have been recent repeated instances in which lower federal courts and the Securities and Exchange Commission ("SEC") have disregarded these principles. On some occasions, judicial adherence to fiduciary principles would have dictated rulings in favor of defendants charged with insider trading, but courts essentially ignored those principles.<sup>16</sup> SEC settlements in insider trading cases also reflect this disregard.<sup>17</sup> On other occasions, courts have ignored fiduciary principles where adherence to them would have established the defendant's liability.<sup>18</sup> These litigated cases and settled proceedings have a common theme: the offense of insider trading involves the wrongful use of material nonpublic information, regardless of whether a fiduciary-like duty is breached.<sup>19</sup>

The SEC has also circumvented fiduciary principles with respect to rules adopted in the wake of *O'Hagan*. This circumvention occurred in connection with Rule 10b5-1's affirmative defenses, which allow insiders who trade securities while aware of material nonpublic information to avoid liability by demonstrating that they traded pursuant to a written plan that pre-existed their awareness of such information.<sup>20</sup> These affirmative defenses clash with the underlying premise of the classical theory: insiders, by virtue of their status as fiduciaries, owe disclosure duties to shareholders when engaging in securities transactions. The SEC likewise ignored fiduciary principles in Rule 10b5-2(b)(1).<sup>21</sup> That rule extends liability under the misappropriation theory to securities transactions based on information subject to a confidentiality agreement, regardless of the nature of the

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§ 551(2)(a) (1977))). Insider trading decisions by lower courts routinely reference "fiduciary-like" relationships or duties. *See, e.g.,* United States v. Chestman, 947 F.2d 551, 572 (2d Cir. 1991) (stating that the misappropriation theory requires a "pre-existing fiduciary-like relationship between the parties"); SEC v. Kornman, 391 F. Supp. 2d 477, 487 n.4 (N.D. Tex. 2005) (stating that the "SEC's complaint sufficiently alleges a fiduciary-like duty under the factors set forth in *Chestman*"). Similarly, Justice Blackmun maintained that the *Chiarella* majority had predicated insider trading liability on a "special relationship akin to fiduciary duty." *Chiarella*, 445 U.S. at 246 (Blackmun, J., dissenting). *See also* WANG & STEINBERG, *supra* note 14, § 5:2 (analyzing *Chiarella* and its "classical special relationship of trust and confidence"). For the sake of brevity, this Article often uses the single term "fiduciary" to identify the relationship on which the classical and misappropriation theories are predicated, but it does not intend the use of that term to exclude any of these other phraseologies.

16. *See infra* Part III.B.1–3.

17. *See id.*

18. *See infra* Part III.B.4.

19. These recent outcomes were foreshadowed years in advance of *O'Hagan*. *See* Donald C. Langevoort, *Words from on High About Rule 10b-5: Chiarella's History, Central Bank's Future*, 20 DEL. J. CORP. L. 865, 897 (1995) [hereinafter Langevoort, *Words from on High*] (observing that the "law of insider trading suggests an almost organic capacity to impose liability for the unfair exploitation of someone else's information, whatever the overarching doctrinal framework").

20. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A) (2008).

21. *Id.* § 240.10b5-2(b)(1).

relationship between the trader and the information's source.<sup>22</sup> Both SEC rules, however, are consistent with the view that insider trading involves the wrongful use of material nonpublic information regardless of the presence of a fiduciary-like duty.

The decade since *O'Hagan* has thus taught us much. First, as I argued shortly after the decision, *O'Hagan's* paradigm of "deception by a fiduciary" was not broad enough to encompass cases involving more novel forms of trading on misappropriated information.<sup>23</sup> Yet more novel forms of outsider trading—such as trading on confidential information stolen by a stranger to the source—have the same deleterious effects on securities markets as secret trading by a fiduciary. The Court in *O'Hagan* failed to provide a convincing rationale as to why the misappropriation theory is limited to outsiders with a fiduciary-like nexus to the information's source. Accordingly, lower courts, encouraged by the SEC, have been willing to allow *O'Hagan's* policy justifications for the federal insider trading proscription to trump the fiduciary-based doctrine actually endorsed by the Court. But a coherent and consistent theory of insider trading liability has yet to emerge as an alternative to the Court's classical and misappropriation approaches.

Relatedly, the last ten years reflect a host of outcomes that return insider trading law almost full circle to the years preceding *Chiarella*. Prior to *Chiarella*, lower courts and the SEC maintained that unequal access to material nonpublic information triggered a disclosure obligation under Rule 10b-5.<sup>24</sup> *Chiarella* and *Dirks* rejected this broad-based disclosure duty and predicated the disclosure obligation on a fiduciary relationship between the parties to the securities transaction. *O'Hagan* then expanded the disclosure obligation to include one that was predicated on a fiduciary relationship between the trader-tipper and the source of the information as well as on a fiduciary relationship between the trading parties. Today, however, insider trading cases do not turn necessarily on the breach of a disclosure obligation flowing from a fiduciary-like relationship. Rather, numerous lower courts and the SEC have in effect concluded that the wrongful use of information constitutes the crux of the insider trading offense and that fiduciary principles are only relevant insofar as they establish such wrongful use.

Most importantly, the last decade has demonstrated the urgent need for redirection. Rather than allowing lower courts and the SEC to continue on a

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22. *Id.* ("[A] duty of trust or confidence exists . . . [w]henever a person agrees to maintain information in confidence").

23. Donna M. Nagy, *Reframing the Misappropriation Theory of Insider Trading Liability: A Post-O'Hagan Suggestion*, 59 OHIO ST. L.J. 1223, 1251–65 (1998).

24. *See, e.g.*, SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968) (defining the duty to disclose broadly by stating that "anyone in possession of material inside information is an 'insider' and must either disclose it to the investing public . . . [or] must abstain from trading in or recommending the securities concerned").

course of revisionism and results-oriented decisionmaking, it would be far better to replace the classical and misappropriation theories with a federal statute that defines and directly prohibits the offense of insider trading. Alternatively, in the absence of legislation by Congress, courts should supplement the classical and misappropriation theories, or replace them entirely, with other fraud-based theories of Rule 10b-5 liability.

The Article proceeds as follows. Part II chronicles the development of fiduciary principles in *Chiarella*, *Dirks*, and *O'Hagan*. The analysis reveals that the Court's affinity for fiduciary principles in insider trading cases originated as a means of confining the scope of liability under Rule 10b-5 to insiders who exploit the corporation's information for their own personal profit. But after *O'Hagan* expanded the scope of Rule 10b-5 liability to include outsiders with no relationship to the corporation that had issued the securities, the Court's slavish devotion to fiduciary principles no longer made much sense.

Part III charts the gradual demise of fiduciary principles in insider trading decisions by lower federal courts, settled enforcement proceedings, and rules adopted by the SEC. It argues that this demise was inevitable given the shaky foundation on which the Supreme Court built its insider trading jurisprudence and the developing consensus that insider trading involves the wrongful use of confidential information regardless of whether a fiduciary-like duty is breached. While most securities litigation under Rule 10b-5 involves a struggle to apply Supreme Court dictates to new sets of facts and circumstances, insider trading jurisprudence is unique in the liberties taken by lower courts and the SEC to simply ignore such dictates whenever their application would produce outcomes inconsistent with overarching policy objectives.<sup>25</sup>

Part IV offers specific suggestions to bring greater coherence and legitimacy to the law of insider trading. Recognizing that everything old can be new again, it begins by examining the proposed "Insider Trading Proscriptions Act of 1987,"<sup>26</sup> which would have amended the Exchange Act to prohibit the use of material nonpublic information to purchase or sell any security if a "person knows (or recklessly disregards) that such information has been obtained wrongfully, or if the purchase or sale would constitute a wrongful use of such information."<sup>27</sup> The analysis highlights how closely the

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25. For a more allegorical description of the liberties taken in insider trading cases, see Saikrishna Prakash, *Our Dysfunctional Insider Trading Regime*, 99 COLUM. L. REV. 1491, 1498 (1999) ("[T]he SEC's dysfunctional regulatory strategy brings to mind unpleasant images of Cinderella's stepsisters who each chopped off portions of a foot in order to stuff the foot into Cinderella's shoe.").

26. The Insider Trading Proscriptions Act of 1987, S. 1380, 100th Cong. (1987) (reconciliation draft discussed at *infra* text accompanying notes 299–300).

27. *Id.* As we shall see, the statutory definition of "wrongful" extended to information that "has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion,



insider trading prohibition in this proposed statute aligns with the outcomes in recently litigated cases and settled proceedings as well as with the affirmative defenses and prohibitions now contained in the SEC's insider trading rules. As second-choice alternatives for change, Part IV advances other theories of insider trading liability that could stand alongside of the classical and misappropriation theories endorsed by the Supreme Court. Specifically, courts could recognize an insider trading theory based on the deceptive acquisition of confidential information, or courts could recognize that insider trading constitutes a "fraud on investors" whenever improperly obtained material nonpublic information is used in a securities transaction.

## II. THE ESSENTIAL LINK BETWEEN FIDUCIARY PRINCIPLES AND THE OFFENSE OF INSIDER TRADING

In the United States, the law of insider trading is essentially judge-made. The critical role courts play is a function of the fact that no federal statute directly prohibits the offense of insider trading.<sup>28</sup> Rather, insider trading may constitute a violation of Rule 10b-5, an SEC rule that broadly prohibits fraud in connection with the purchase or sale of any security.<sup>29</sup> The lack of a

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misappropriation, a breach of any fiduciary duty, any personal or other relationship of trust and confidence, or any contractual or employment relationship." *Id.*

28. Although Congress has yet to enact a statute that directly prohibits insider trading, it has enacted stiff civil penalties for the offense. *See* Securities Exchange Act of 1934 (Exchange Act) § 21A, 15 U.S.C. § 78u-1 (2000) (authorizing the SEC to seek a monetary penalty of up to three times the profit gained or loss avoided through illegal insider trading and tipping); *see also infra* text accompanying notes 289–294 (discussing congressional authorization of civil penalties for insider trading). In addition, Congress addressed the topic of insider trading in Section 16(b) of the Exchange Act, 15 U.S.C. § 78p(b), which provides that officers, directors, and shareholders holding more than ten percent of the stock in public companies may be liable to the corporation, or to shareholders suing on its behalf, for any profits they obtain from purchasing and selling the company's stock within a six-month time frame. However, although a purpose of this "short-swing" profit provision was to prevent the unfair use of confidential corporate information, the provision applies regardless of whether the director, officer, or controlling shareholder was aware of material nonpublic information at the time of the short-swing trade. DONNA M. NAGY, RICHARD W. PAINTER & MARGARET V. SACHS, *SECURITIES LITIGATION AND ENFORCEMENT: CASES AND MATERIALS* 454–56 (2d ed. 2008).

29. 17 C.F.R. § 240.10b-5 (2008). *See supra* note 5 for the text of Rule 10b-5. Insider trading in violation of Rule 10b-5 may be prosecuted by the SEC as a civil offense, 17 C.F.R. § 240.10b-5, or may be criminally prosecuted by the Department of Justice ("DOJ") under Section 32(a) of the Exchange Act, 15 U.S.C. § 78ff(a), which authorizes fines of not more than \$5 million and/or imprisonment for not more than twenty years for willful violations of Exchange Act provisions and rules. The DOJ may also pursue criminal prosecutions for insider trading under federal statutes prohibiting mail fraud or wire fraud, 18 U.S.C. §§ 1341, 1343, or under a relatively new federal statute prohibiting fraud in connection with the purchase or sale of securities of public companies, 18 U.S.C. § 1348 (enacted as part of the Sarbanes-Oxley Act of 2002, Pub. L. No. 107-204, 116 Stat. 745).

specific statutory prohibition means that insider trading is generally unlawful only to the extent that it constitutes deceptive conduct.<sup>30</sup>

To determine whether conduct is deceptive within the meaning of Rule 10b-5, federal courts have looked to the common law of fraud and deceit.<sup>31</sup> Under the common law, an individual committed fraud by intentionally misrepresenting a material fact on which another person relied to her detriment.<sup>32</sup> Thus, the common law generally imposed liability for affirmative misstatements. Fraud by silence was actionable only in limited circumstances, and the default rule was one of caveat emptor.<sup>33</sup>

The challenge in prosecuting insider trading as a violation of Rule 10b-5 thus turns on characterizing a defendant's silence as a fraud.<sup>34</sup> Insider traders remain silent about the facts they know and others do not know—typically secret good news or bad news about a corporation. Insider traders also remain silent when they obtain their informational advantage improperly, whether through the breach of an obligation to keep such information confidential or through outright theft or conversion. But for these silences to constitute deception in violation of Rule 10b-5, the insider trader must be under some type of obligation to speak. The classical and

30. Insider trading prosecutions under Rule 14e-3, 17 C.F.R. § 240.14e-3, constitute a notable exception. Promulgated by the SEC in 1980, pursuant to its rulemaking authority under Section 14(e) of the Exchange Act, 15 U.S.C. § 78n, Rule 14e-3 functions as a special insider trading rule applying only in the context of a tender offer. Specifically, once “substantial steps” toward a tender offer have been taken, Rule 14e-3 prohibits trading by any person in possession of material nonpublic information relating to that tender offer when that person knows or has reason to know that the information is nonpublic and was received from the offeror, the target, or any person acting on behalf of either the offeror or the target. 17 C.F.R. § 240.14e-3. Although Rule 14e-3 does not require any breach of fiduciary duty for liability to attach, the Supreme Court in *O’Hagan* upheld the validity of the rule, concluding that the SEC’s rulemaking authority pursuant to Section 14(e) was more expansive than its authority pursuant to Section 10(b). *See* United States v. O’Hagan, 521 U.S. 642, 672–73 (1997) (maintaining that Rule 14e-3 qualifies as a “means reasonably designed to prevent” fraud in connection with tender offers within the meaning of Section 14(e)).

31. *Dura Pharm., Inc. v. Broudo*, 544 U.S. 336, 343 (2005) (maintaining that implied private actions under Rule 10b-5 “resemble in many (but not all) respects common-law deceit and misrepresentation actions” (citations omitted)); *Blue Chip Stamps v. Manor Drug Stores*, 421 U.S. 723, 744 (1975) (“[I]t is not inappropriate to advert briefly to the tort of misrepresentation and deceit, to which a claim under Rule 10b-5 certainly has some relationship.”).

32. *See* RESTATEMENT (SECOND) OF TORTS § 525 (1977) (stating that in order to establish liability for fraud under tort law, the plaintiff must prove that the defendant “fraudulently [made] a misrepresentation of fact, opinion, intention or law for the purpose of inducing [the plaintiff] to act . . . upon it . . . [causing] pecuniary loss . . . by his justifiable reliance upon the misrepresentation”).

33. *See infra* text accompanying notes 44–46.

34. *See* Jill E. Fisch, *Start Making Sense: An Analysis and Proposal for Insider Trading Regulation*, 26 GA. L. REV. 179, 183 (1991) (observing that the federal prohibition of insider trading “has been developed within the framework of federal securities fraud” and concluding that “the resulting case law contains logical as well as interpretive flaws”).

misappropriation theories of insider trading liability establish the circumstances under which such a disclosure duty arises, and, as we shall see, under either of the Supreme Court's theories, the existence of a fiduciary-like relationship is essential.<sup>35</sup>

#### A. THE CLASSICAL THEORY OF INSIDER TRADING

The United States Supreme Court first considered Rule 10b-5's applicability to the offense of insider trading in *Chiarella v. United States*.<sup>36</sup> In that case, Vincent Chiarella, a financial printer hired by acquiring corporations to print takeover documents, used his ingenuity to decipher code names assigned to acquisition targets.<sup>37</sup> Based on this confidential information, Chiarella purchased shares in the target companies, and when the tender offers were later announced to the public, he reaped substantial profits by selling those shares into the rising market.<sup>38</sup>

In prosecuting the indictment against Chiarella, the government argued that he had violated Rule 10b-5 by remaining silent about the secret good news that he used in his securities transaction with shareholders of the target companies.<sup>39</sup> Courts in the circuit where Chiarella's trial took place had previously accepted this theory of "parity of access to information."<sup>40</sup> That is, courts in the Second Circuit were of the view that "anyone in possession of material inside information must either disclose it to the investing public, or . . . must abstain from trading in or recommending the securities concerned while such inside information remains undisclosed."<sup>41</sup> A jury convicted Chiarella for his insider trading and sentenced him to jail.<sup>42</sup>

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35. See Stephen M. Bainbridge, *Incorporating State Law Fiduciary Duties into the Federal Insider Trading Prohibition*, 52 WASH. & LEE L. REV. 1189, 1190 (1995) [hereinafter Bainbridge, *Incorporating State Law*] (stating that a person "violates the federal insider trading prohibition only if his trading activity breached a fiduciary duty owed either to the investor with whom he trades or to the source of the information" and thus the prohibition "has no force or substance until it has been filled with fiduciary duty concepts"); Donald C. Langevoort, *Insider Trading and the Fiduciary Principle: A Post-Chiarella Restatement*, 70 CAL. L. REV. 1, 3 (1982) [hereinafter Langevoort, *Fiduciary Principle*] (observing that "*Chiarella* has made the fiduciary principle a consideration of utmost importance"); Richard W. Painter, Kimberly D. Krawiec & Cynthia A. Williams, *Don't Ask, Just Tell: Insider Trading After United States v. O'Hagan*, 84 VA. L. REV. 153, 175 (1998) (recognizing that the "critical determination" under the misappropriation theory "is whether a fiduciary relationship exists creating a duty to disclose to the principal the fiduciary's use of information").

36. *Chiarella v. United States*, 445 U.S. 222 (1980). Much of the following description of the classical and misappropriation theories, as well as the analysis of recent cases and rules, is based on the more extensive discussion in RALPH C. FERRARA, DONNA M. NAGY & HERBERT THOMAS, *FERRARA ON INSIDER TRADING AND THE WALL* 2-25 to -28, 2-35 to -38 (2008).

37. *Chiarella*, 445 U.S. at 224.

38. *Id.*

39. *Id.* at 226-27.

40. See SEC v. Texas Gulf Sulphur, 401 F.2d 833, 848 (2d Cir. 1968).

41. *Id.*

42. *Chiarella*, 445 U.S. at 222.

The Supreme Court reversed Chiarella's conviction, and in so doing, entrenched what has become known as the classical theory of insider trading. Writing for the majority, Justice Powell looked to the common law of fraud and deceit to determine whether Chiarella's silence about material facts in a securities transaction violated Rule 10b-5.<sup>43</sup> Specifically, he stated that:

At common law, misrepresentation made for the purpose of inducing reliance upon the false statement is fraudulent. But one who fails to disclose material information prior to the consummation of a transaction commits fraud only when he is under a duty to do so. *And the duty to disclose arises when one party has information "that the other [party] is entitled to know because of a fiduciary or other similar relation of trust and confidence between them."*<sup>44</sup>

The Court's authority for the above statement was *The Restatement (Second) of Torts* § 551(2)(a).<sup>45</sup> That section delineated five independent exceptions to the general rule at common law that only affirmative misstatements could be actionable as fraud.<sup>46</sup> As emphasized by Justices Blackmun and Marshall in their dissent, the final exception in the *Restatement* would have supported a disclosure duty "where one party's superior knowledge of essential facts renders a transaction without disclosure inherently unfair."<sup>47</sup> But Justice Powell ignored this exception as well as three of the others, focusing entirely

43. *See id.* at 228.

44. *Id.* at 228 (emphasis added) (quoting RESTATEMENT (SECOND) OF TORTS § 551(2)(a) (1977)).

45. RESTATEMENT (SECOND) OF TORTS § 551(2)(a)–(e) (1977).

46. *Id.* The five exceptions provide that a knowledgeable party must disclose:

- (a) matters known to him that the other is entitled to know because of a fiduciary or other similar relation of trust and confidence between them; and
- (b) matters known to him that he knows to be necessary to prevent his partial or ambiguous statement of the facts from being misleading; and
- (c) subsequently acquired information that he knows will make untrue or misleading a previous representation that when made was true or believed to be so; and
- (d) the falsity of a representation not made with the expectation that it would be acted upon, if he subsequently learns that the other is about to act in reliance upon it in a transaction with him; and
- (e) facts basic to the transaction, if he knows that the other is about to enter into it under a mistake as to them, and that the other, because of the relationship between them, the customs of the trade or other objective circumstances, would reasonably expect a disclosure of those facts.

*Id.*

47. *Chiarella*, 445 U.S. at 248 (Blackmun, J., dissenting) (citing Fleming James, Jr. & Oscar S. Gray, *Misrepresentation—Part II*, 37 MD. L. REV. 488, 526–27 (1978); 3 RESTATEMENT (SECOND) OF TORTS § 551(e) cmt 1 (1977)).

on the first exception, which rooted disclosure duties in fiduciary-like relationships such as “the relationship between a corporate insider and the stockholders of his corporation . . . .”<sup>48</sup> Under this fiduciary framework, Chiarella’s silence in securities transactions with target shareholders could not be a fraud under Rule 10b-5 because “he was not a fiduciary, [and] he was not a person in whom the sellers had placed their trust and confidence.”<sup>49</sup> Justice Powell invoked the term “fiduciary” a total of seven times in *Chiarella*’s majority opinion.<sup>50</sup>

*Chiarella*’s fiduciary framework functioned as a means of retrenchment. That is, the Court developed a new theory of insider trading liability to replace the broader parity-of-access approach that lower courts and the SEC had embraced.<sup>51</sup> Because this new theory centered on the fiduciary relationship between insiders and shareholders, it narrowed substantially the categories of persons covered by Rule 10b-5’s prohibition. The theory therefore prevented what, at least in Justice Powell’s view, was overreaching on the part of government prosecutors.<sup>52</sup> Yet, at the same time, the fiduciary framework allowed for the prosecution of traditional insiders who misused confidential information for their own personal profit.<sup>53</sup> Although such trading by officers and directors emphatically was not before the Court, it was nonetheless a scenario that troubled Justice Powell greatly.<sup>54</sup>

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48. *Chiarella*, 445 U.S. at 227.

49. *Id.* at 232.

50. *Id.* at 227 n.8, 228 & n.10, 229, 230 n.12, 232 & n.14. The *Chiarella* majority also invoked the phrase “trust and confidence” four times. *Id.* at 228, 230, 232.

51. See Bainbridge, *Path Dependent Choice*, *supra* note 14, at 1599 (“*Chiarella* radically limited the scope of the insider trading prohibition as it had been defined in *Texas Gulf Sulphur*.”); Langevoort, *Words from on High*, *supra* note 19, at 872 (emphasizing that the new rule announced in *Chiarella* “clearly and deliberately cut back the reach of Rule 10b-5 as a general weapon against unfair information advantages”); A.C. Pritchard, *United States v. O’Hagan: Agency Law and Justice Powell’s Legacy for the Law of Insider Trading*, 78 B.U. L. REV. 13, 15 (1998) [hereinafter Pritchard, *Agency Law*] (“Powell sought to restrain the government’s attack against insider trading by anchoring insider trading law to his interpretation of the common law of deceit.”).

52. See A.C. Pritchard, *Justice Lewis F. Powell, Jr., and the Counterrevolution in the Federal Securities Laws*, 52 DUKE L. J. 841, 933 (2003) [hereinafter Pritchard, *Counterrevolution*] (stating that “[a]s Powell saw it, courts had a responsibility to check such overreaching by the executive branch” and concluding that “*Chiarella* was a conscious attempt to bring precision and rigor to an area of the law in which the lower courts had strayed from Congress’s purposes”).

53. See *Chiarella*, 445 U.S. at 230 (“Application of a duty to disclose prior to trading guarantees that corporate insiders, who have an obligation to place the shareholder’s welfare before their own, will not benefit personally through fraudulent use of material, nonpublic information.”).

54. *Id.*; see Pritchard, *Counterrevolution*, *supra* note 52, at 947 (“[Powell’s] distaste for the abuse of trust of insider trading led him to read the common law of fraud broadly in *Chiarella* to make room for a prohibition under section 10(b).”).

The next insider trading case to reach the Supreme Court was *Dirks v. SEC*,<sup>55</sup> for which Justice Powell again wrote the majority opinion, this time referencing the term “fiduciary” a noteworthy thirty-three times.<sup>56</sup> The question presented in *Dirks* was whether Raymond Dirks, a securities analyst who specialized in insurance companies, could be held liable under Rule 10b-5 for “tipping” material nonpublic information about Equity Funding of America.<sup>57</sup> The information, which was conveyed to Dirks by a former Equity Funding official, concerned a massive fraud that was occurring at the company.<sup>58</sup> After verifying the information given to him by this whistleblower, Dirks shared his knowledge about the fraud with a number of his clients, who then avoided huge losses by promptly selling their Equity Funding stock.<sup>59</sup> Like Chiarella, Dirks was not a fiduciary to the shareholders on the other side of his clients’ securities transactions. But the SEC sought to distinguish the facts of this case from *Chiarella*, arguing that a tippee “inherits [a disclosure] obligation to shareholders whenever he receives inside information from an insider.”<sup>60</sup> Thus, in the SEC’s view, “anyone who knowingly receives nonpublic material information from an insider has a fiduciary duty to disclose before trading.”<sup>61</sup>

The Court in *Dirks* once again rejected the SEC’s theory, maintaining that it conflicted with *Chiarella*’s principle “that only some persons, under some circumstances, will be barred from trading while in possession of material nonpublic information.”<sup>62</sup> The Court was concerned about the chilling effect from a broad prohibition, noting specifically “[the] inhibiting influence on the role of market analysts,” which “is necessary to the preservation of a healthy market.”<sup>63</sup> But the Court was also quick to recognize the “need for a ban on some tippee trading.”<sup>64</sup> As the Court saw it:

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55. *Dirks v. SEC*, 463 U.S. 646 (1983).

56. *Id.* at 652, 653, 654, 655 & n.14, 656 & n.15, 659, 660 & n.20, 661, 662 & n.22, 663 n.23, 664, 665 & n.26, 667 & n.27. The Court also made reference to a relationship of “trust and confidence”:

We were explicit in *Chiarella* in saying that there can be no duty to disclose where the person who has traded on inside information “was not [the corporation’s] agent, . . . was not a fiduciary, [or] was not a person in whom the sellers [of the securities] had placed their trust and confidence.”

*Id.* at 654 (quoting *Chiarella*, 445 U.S. at 232).

57. *Id.* at 648–51.

58. *Id.* at 649.

59. *Id.*

60. *Dirks*, 463 U.S. at 655–56.

61. *Id.*

62. *Id.* at 657.

63. *Id.* at 658.

64. *Id.* at 659.

Not only are insiders forbidden by their fiduciary relationship from personally using undisclosed corporate information to their advantage, but they also may not give such information to an outsider for the same improper purpose of exploiting the information for their personal gain. Similarly, the transactions of those who knowingly participate with the fiduciary in such a breach are “as forbidden” as transactions “on behalf of the trustee himself.” . . . [A] contrary rule “would open up opportunities for devious dealings in the name of others that the trustee could not conduct in his own.”<sup>65</sup>

Thus, in Justice Powell’s view, insiders of a corporation should not be able to funnel information to persons outside the corporation with the purpose of exploiting that information for personal profit.<sup>66</sup>

Having used policy considerations to justify the need for a ban on some tippee trading, the Court then faced the daunting task of delineating the circumstances under which a tippee’s silence about material facts in securities transactions could be deemed a fraud actionable under Rule 10b-5. Unwilling to unmoor the disclosure duty from the fiduciary framework he constructed in *Chiarella*, Justice Powell emphasized that the tippee’s disclosure duty (if any) must be “derivative from that of the insider’s duty.”<sup>67</sup> That is:

[A] tippee assumes a fiduciary duty to the shareholders of a corporation not to trade on material nonpublic information only when the insider has breached his fiduciary duty to the shareholders by disclosing the information to the tippee and the tippee knows or should know that there has been a breach.<sup>68</sup>

Thus, as Professor Donald Langevoort has observed, it is the tipper and the tippee’s co-participation in the insider’s breach of duty that serves to “fiduciarize” the tippee.<sup>69</sup>

Yet the Court also recognized that not all disclosures of confidential corporate information violate the duty that an insider owes to shareholders. In the Court’s view, only improper disclosures constitute a breach of fiduciary duty, and thus, only improper disclosures would operate to “fiduciarize” the tippee.<sup>70</sup> More specifically, because “a purpose of the securities laws was to eliminate the ‘use of inside information for personal

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65. *Dirks*, 463 U.S. at 659 (quoting *Mosser v. Darrow*, 341 U.S. 267, 271–72 (1951)).

66. *Id.*

67. *Id.* at 659.

68. *Id.* at 660.

69. Donald C. Langevoort, *The Demise of Dirks: Shifting Standards for Tipper-Tippee Liability*, 8 No. 6 INSIGHTS 23, 24 (1994) [hereinafter Langevoort, *The Demise of Dirks*].

70. *Dirks*, 463 U.S. at 662.

advantage,”<sup>71</sup> the Court maintained that liability for Rule 10b-5 should turn on the tipper’s motive for disclosing the confidential information.<sup>72</sup> The test, according to the Court, involves “whether the insider personally will benefit, directly or indirectly, from his disclosure. Absent some personal gain, there has been no breach of duty to stockholders. And absent a breach by the insider, there is no derivative breach.”<sup>73</sup> This “personal benefit” requirement sharply distinguished a fiduciary’s breach of the duty of loyalty (which would trigger Rule 10b-5 liability) from a breach of a fiduciary’s duty of care (which would not result in a Rule 10b-5 violation).<sup>74</sup> The Court, however, made clear that courts should broadly construe the requirement of a personal benefit for tipper–tippee liability, and cited examples, such as a “relationship between the insider and the recipient that suggests a quid pro quo from the latter, or an intention to benefit the particular recipient” and “when an insider makes a gift of confidential information to a trading relative or friend.”<sup>75</sup>

But *Dirks* himself did not become privy to the confidential information about Equity Funding as the result of an insider’s improper breach of the duty of loyalty. The former executive shared the information with *Dirks* as a means of exposing the company’s fraud; he was not looking to make a gift of that information nor was the executive seeking a personal benefit.<sup>76</sup> Accordingly, *Dirks* could not be held liable under Rule 10b-5 for “participating after the fact” in a nonexistent breach.<sup>77</sup>

Because the classical theory premises Rule 10b-5 liability on a fiduciary’s deceptive silence in securities transactions with a corporation’s shareholders, it left a wide gap in the law of insider trading. To be sure, the theory triggered liability when an officer or director traded in the corporation’s securities while aware of material nonpublic information or tipped others to trade. The Supreme Court also viewed the theory as flexible enough to extend liability to trading by employees and temporary agents of the corporation who, while not technically fiduciaries, were nonetheless viewed as owing a fiduciary-like duty of trust and confidence to the corporation’s

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71. *Id.* at 662 (quoting *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 n.15 (1961)).

72. *Id.* at 664.

73. *Id.* at 662.

74. See Bainbridge, *Incorporating State Law*, *supra* note 35, at 1195 (emphasizing that “[w]hat is proscribed is not merely a breach of confidentiality by the insider, but rather a breach of the duty of loyalty imposed on all fiduciaries to avoid personally profiting from information entrusted to them”); Pritchard, *Counterrevolution*, *supra* note 52, at 942 (stating that under Powell’s reasoning, “[g]arden variety breaches of the duty of care were clearly out; tipping required a breach of the duty of loyalty”).

75. *Dirks*, 463 U.S. at 664 (emphasis omitted).

76. *Id.* at 667.

77. *Id.*



shareholders.<sup>78</sup> But the classical theory allowed persons outside the issuing corporation to trade with impunity, even though such persons may have gained their knowledge through unlawful means. By virtue of their “outsider” status, persons unconnected to the issuing corporation lacked the fiduciary nexus that was necessary to render their silence a fraud actionable under Rule 10b-5.

### B. THE MISAPPROPRIATION THEORY

In the 1997 case of *United States v. O'Hagan*,<sup>79</sup> the Supreme Court endorsed an alternative theory of insider trading under Rule 10b-5, based once again on a fiduciary principle. Labeled the “misappropriation theory,” this theory had its judicial roots in Justice Stevens’s concurring opinion in *Chiarella*.<sup>80</sup> While agreeing with Justice Powell’s view that any duty of disclosure owed to marketplace traders must arise from a fiduciary relationship, Justice Stevens maintained that “[r]espectable arguments could be made” that Chiarella had violated Rule 10b-5 by breaching a duty of silence “he unquestionably owed to his employer and to his employer’s customers.”<sup>81</sup> That is, by purchasing stock in the target companies, Chiarella arguably defrauded the acquiring companies that had entrusted his employer with the confidential tender offer information. Justice Stevens noted, however, that the majority “wisely” left the validity of this fraud-on-the-source theory “for another day” because it was not presented to the jury, and thus, did not form the basis of Chiarella’s conviction.<sup>82</sup>

Other Justices on the *Chiarella* Court had expressed a willingness to support an even broader version of a misappropriation theory that would have applied even in the absence of a fiduciary relationship between the trader and the information’s source. The principal proponent of this broader theory was Chief Justice Burger. He argued that while silence about material facts in business transactions is generally permissible absent a fiduciary relationship between the parties, that general rule “should give way when an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means.”<sup>83</sup> Thus, as the Chief Justice saw it, Chiarella’s silence about facts pertaining to the planned tender offers constituted a fraud on the investors with whom he was trading.<sup>84</sup> In other words, Chiarella owed a disclosure duty to marketplace

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78. *Id.* at 655 n.14 (“Under certain circumstances, such as where corporate information is revealed legitimately to an underwriter, accountant, lawyer, or consultant working for the corporation, these outsiders may become fiduciaries of the shareholders.”).

79. *United States v. O'Hagan*, 521 U.S. 642 (1997).

80. *See Chiarella v. United States*, 445 U.S. 222, 238 (1980) (Stevens, J., concurring).

81. *Id.*

82. *Id.*

83. *Id.* at 240 (Burger, C.J., dissenting).

84. *Id.* at 245.

traders by virtue of the fact that he “misappropriated—stole, to put it bluntly—valuable nonpublic information entrusted to him in the utmost confidence.”<sup>85</sup>

Although Chief Justice Burger’s “fraud on investors” approach was the broader misappropriation theory, it was Justice Stevens’s “fraud on the source” version that commanded acceptance in the lower courts, first from the Second Circuit in *United States v. Newman*<sup>86</sup> and then from several other circuits.<sup>87</sup> But the lower courts’ embrace of the “fraud on the source” version was largely a function of the government’s litigation strategy. That is, as one scholar explains, the government deliberately did not pursue the “fraud on investors” theory in *Newman* because “[i]t was considered too confusing to present to the jury in tandem with the fraud on the source theory.”<sup>88</sup> The government employed a similar strategy in *United States v. O’Hagan* in its briefs and oral argument before the Court, framing the insider trading issue solely as a fraud on the source.<sup>89</sup>

The facts of *O’Hagan* involved securities trading by James O’Hagan, a former partner at Dorsey & Whitney, a large Minneapolis law firm.<sup>90</sup> O’Hagan learned that a law-firm client, Grand Metropolitan (“Grand Met”),

85. *Chiarella*, 445 U.S. at 245. Interestingly, in its brief to the Supreme Court in *Chiarella*, the government argued that Chiarella’s securities trading based on misappropriated information defrauded *both* the source of the information and the shareholders on the other side of his transactions. Brief of Respondent United States at 24, 28, 38–39, *Chiarella v. United States*, 445 U.S. 222 (1979) (No. 78-1202), 1979 WL 199454.

86. *United States v. Newman*, 664 F.2d 12 (2d Cir. 1981). In *United States v. Carpenter*, 791 F.2d 1024, 1029 (2d Cir. 1986), the Second Circuit applied the misappropriation theory in a case involving a *Wall Street Journal* reporter and his tippee, who had traded securities on the basis of information that would be appearing in the reporter’s upcoming “Heard on the Street” columns. The court found the defendants guilty of violating Section 10(b) and Rule 10b-5 as well as the federal-mail and wire-fraud statutes. *Carpenter*, 791 F.2d at 1025–26. The Supreme Court unanimously affirmed the defendants’ convictions for mail and wire fraud but was equally divided (4–4) on the validity of the misappropriation theory and thus affirmed the Section 10(b) and Rule 10b-5 convictions without opinion. *Carpenter v. United States*, 484 U.S. 19, 24 (1987).

87. Prior to the Court’s decision in *O’Hagan*, the Third, Seventh, and Ninth Circuits had joined the Second Circuit in endorsing the misappropriation theory. See, e.g., *SEC v. Cherif*, 933 F.2d 403, 410 (7th Cir. 1991); *SEC v. Clark*, 915 F.2d 439, 449 (9th Cir. 1990); *Rothberg v. Rosenbloom*, 771 F.2d 818, 823 (3d Cir. 1985). The misappropriation theory was rejected by the Fourth Circuit in *United States v. Bryan*, 58 F.3d 933, 944 (4th Cir. 1995), and by the Eighth Circuit in *United States v. O’Hagan*, 92 F.3d 612, 614, 620 (8th Cir. 1996), *rev’d*, 521 U.S. 642 (1997).

88. Langevoort, *Words from on High*, *supra* note 19, at 883.

89. The “fraud on investors” theory was, however, advanced in an amicus brief. Brief for North American Securities Administrators Ass’n, Inc. et al. as Amici Curiae Supporting Petitioner at 11–14, *United States v. O’Hagan*, 521 U.S. 642 (1997) (No. 96-842), 1997 WL 86236 (“Chief Justice Burger’s disclosure-based misappropriation theory of liability is a sound and sensible application of Section 10(b) and Rule 10b-5, and it satisfies the statutory requirements of deception and a connection to the purchase or sale of securities.”).

90. *O’Hagan*, 521 U.S. at 642.

was planning a hostile tender offer for shares of Pillsbury Corporation.<sup>91</sup> In desperate need of money to cover his prior thefts of client funds from trust accounts, O'Hagan purchased call options for Pillsbury stock as well as shares of common stock.<sup>92</sup> He later realized a profit of \$4.3 million when he exercised those options and sold his shares in Pillsbury upon Grand Met's tender-offer announcement.<sup>93</sup> A jury convicted O'Hagan of multiple offenses, including insider trading under Rule 10b-5, and sentenced him to forty-one months of imprisonment.<sup>94</sup> The Eighth Circuit, however, overturned that conviction, holding that Rule 10b-5 liability may not be grounded on a misappropriation theory of securities fraud.<sup>95</sup> The Supreme Court disagreed and reversed the Eighth Circuit's decision.<sup>96</sup>

Justice Ginsburg's majority opinion endorsed a misappropriation theory that was "limited to those who breach a recognized duty."<sup>97</sup> The opinion's discussion of the misappropriation theory referenced the term "fiduciary" seventeen times<sup>98</sup> and drew substantially from the common law of agency.<sup>99</sup> At the outset, the Court stated that "[t]he 'misappropriation theory' holds that a person commits fraud 'in connection with' a securities transaction, and thereby violates § 10(b) and Rule 10b-5, when he misappropriates confidential information for securities trading purposes, in breach of a duty owed to the source of the information."<sup>100</sup> Drawing a distinction between this theory and the classical theory, the Court maintained that: "[i]n lieu of

91. *Id.*

92. *Id.* at 648 (referencing the charge in the indictment that "O'Hagan used the profits he gained through this trading to conceal his previous embezzlement and conversion of unrelated client trust funds"); *see also id.* at 649 n.2 ("O'Hagan was convicted of theft in state court, sentenced to 30 months' imprisonment, and fined.").

93. *Id.* at 642.

94. *Id.* at 649.

95. *United States v. O'Hagan*, 92 F.3d 612, 620 (8th Cir. 1996), *rev'd*, 521 U.S. 642 (1997).

96. *O'Hagan*, 521 U.S. at 678.

97. *Id.* at 666.

98. *Id.* at 647, 652, 653, 654, 655, 656, 661, 663, 667, 669, 670, 671, 673 n.17, 675, 676. In discussing the misappropriation theory, the Court also referenced the phrase "trust and confidence" five times. *Id.* at 652, 653, 662, 670.

99. *See id.* at 654–55 (citing RESTATEMENT (SECOND) OF AGENCY §§ 390, 395 (1958) (discussing an agent's disclosure obligation regarding use of confidential information)); *see also* Pritchard, *Agency Law*, *supra* note 51, at 15 (emphasizing that the "Court's decision in *O'Hagan* breaks new ground in establishing a foundation for insider trading based on common-law agency principles"). At one point in the opinion, the Court indirectly referenced the violation of a "contractual" obligation. *O'Hagan*, 521 U.S. at 663 ("misappropriation theory bars only 'trading on the basis of information that the wrongdoer converted to his own use in violation of some fiduciary, contractual, or similar obligation to the owner or rightful possessor of the information'" (quoting Barbara B. Aldave, *Misappropriation: A General Theory of Liability for Trading on Nonpublic Information*, 13 HOFSTRA L. REV. 101, 122 (1984))). Used in that context, the term "contractual" obligation appears to describe an obligation that creates fiduciary-like duties of trust and confidence, such as those that would flow from an agency relationship.

100. *O'Hagan*, 521 U.S. at 652.

premising liability on a fiduciary relationship between company insider and purchaser or seller of the company's stock, the misappropriation theory premises liability on a fiduciary-turned trader's deception of those who entrusted him with access to confidential information."<sup>101</sup> Thus, as the Court saw it, "a fiduciary's undisclosed, self-serving use of a principal's information to purchase or sell securities, in breach of a duty of loyalty and confidentiality," violates Rule 10b-5 because such trading "defrauds the principal of the exclusive use of that information."<sup>102</sup> The Court clearly credited the government with framing the theory it was endorsing.<sup>103</sup> Indeed, as one scholar noted, "[i]n resolving the case, the majority did essentially what the government told it to do."<sup>104</sup>

Having provided at the outset a ringing endorsement to the "fraud on the source" misappropriation theory, Justice Ginsburg then justified that holding by elaborating on the textual requirements for liability under Section 10(b). Focusing first on the textual element of "deception," the Court emphasized that misappropriators "deal in deception."<sup>105</sup> Specifically, a "fiduciary who '[pretends] loyalty to the principal while secretly converting the principal's information for personal gain' dupes or defrauds the principal."<sup>106</sup> Yet, the Court also recognized that full disclosure by the fiduciary to the principal would negate this essential element:

Because the deception essential to the misappropriation theory involves feigning fidelity to the source of information, if the fiduciary discloses to the source that he plans to trade on the nonpublic information, there is no "deceptive device" and thus no § 10(b) violation—although the fiduciary-turned-trader may remain liable under state law for breach of a duty of loyalty.<sup>107</sup>

Turning next to the textual requirement that the defendant's deception must be "in connection with the purchase or sale of [a] security," the Court reasoned that this element was satisfied because:

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101. *Id.*

102. *Id.*

103. *See, e.g., id.* at 655 n.6 ("Under the misappropriation theory urged in this case, the disclosure obligation runs to the source of the information, here, Dorsey & Whitney and Grand Met." (emphasis added)); *id.* at 654 ("Deception through nondisclosure [to the source of the information] is central to the theory of liability for which the Government seeks recognition." (emphasis added)); *id.* at 655 (reconciling "[t]he misappropriation theory advanced by the Government" with *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462 (1977) (emphasis added)).

104. Bainbridge, *Path Dependent Choice*, *supra* note 14, at 1638 (observing that "the misappropriation section of Justice Ginsburg's opinion repeatedly quoted from or cited to the government's brief and oral argument, almost always approvingly").

105. *O'Hagan*, 521 U.S. at 653.

106. *Id.* at 653–54 (quoting Brief for the Petitioner, *O'Hagan*, 521 U.S. 642 (1997) (No. 96-842), 1997 WL 86306).

107. *Id.* at 655.

[T]he fiduciary's fraud is consummated, not when the fiduciary gains the confidential information, but when, without disclosure to his principal, he uses the information to purchase or sell securities. The securities transaction and the breach of duty thus coincide. This is so even though the person or entity defrauded is not the other party to the trade, but is, instead, the source of the nonpublic information.<sup>108</sup>

Under this reasoning, the Court had little trouble concluding that O'Hagan's purchases of stock in Pillsbury on the basis of his law firm's and its client's confidential information constituted deceptive conduct "in connection with the purchase or sale of [a] security."<sup>109</sup>

In addition to its arguments based on the text of the statute, the Court in *O'Hagan* also bolstered the misappropriation theory with considerations of policy. Early on in the opinion, the Court emphasized that the misappropriation theory was designed to "protec[t] the integrity of the securities markets against abuses by 'outsiders' to a corporation who have access to confidential information that will affect th[e] corporation's security price when revealed."<sup>110</sup> The Court also linked the misappropriation theory to the policy goal of enhancing investor confidence, reasoning that while "informational disparity is inevitable in the securities markets, investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law."<sup>111</sup>

Although the misappropriation theory endorsed in *O'Hagan* extended Rule 10b-5 liability to a host of scenarios involving "outsiders" to the corporation in which the securities were traded, its "deception by a fiduciary" paradigm failed to capture all instances of trading on misappropriated information. For example, as the government acknowledged in oral argument, the misappropriation theory would not extend to securities trading by a stranger who had stolen confidential information from its source.<sup>112</sup> Moreover, as the Court itself recognized,

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108. *Id.* at 656.

109. *Id.* at 643, 659.

110. *O'Hagan*, 521 U.S. at 653 (citing Brief for the Petitioner, *supra* note 106, at 14).

111. *Id.* at 658.

112. See Transcript of Oral Argument at 5, *O'Hagan*, 521 U.S. 642 (1998) (No. 96-842), 1997 WL 182584. The transcript reads:

MR. DREEBEN: The misappropriation theory . . . involves . . . an agent entrusted with information by a principal under the understanding between the parties that the agent would not use that information for any personal gain without obtaining the principal's agreement.

QUESTION: Well, Mr. Dreeben, then if someone stole the lawyer's briefcase and discovered the information and traded on it, no violation?

even fiduciaries could escape Rule 10b-5 liability if they brazenly shared with their principal their intention to trade.<sup>113</sup>

Unfortunately, the Court in *O'Hagan* never came to terms with why its misappropriation theory “was limited to those who breached a recognized duty” and why “feigning fidelity” to the information’s source was essential. To be sure, the Court included a footnote referencing Chief Justice Burger’s alternative theory of liability, which viewed the act of trading on misappropriated information as a “fraud on investors.”<sup>114</sup> Because this theory focused on the use of unlawfully obtained information, it would have extended liability to securities trading by non-fiduciary thieves and to fiduciaries who trade with disclosure to, but without permission from, the source. But in referencing the Burger approach, the Court commented only that “[t]he Government does not propose that we adopt a misappropriation theory of that breadth.”<sup>115</sup> The sentiment behind this cryptic statement is difficult to understand. Congress essentially codified Chief Justice Burger’s “fraud on investors” approach in Section 20A of the Exchange Act,<sup>116</sup> which grants an express private right of action to those investors trading contemporaneously with an insider trader.<sup>117</sup> Moreover, any concern the Court raised about expansive private liability would have been unwarranted, since insider trading cases are typically brought by the government—the

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MR. DREEBEN: That’s correct, Justice O’Connor.

*Id.*

113. See *supra* text accompanying note 107; see also Painter et al., *supra* note 35, at 180 (emphasizing that “a fiduciary is permitted to trade even without the principal’s consent so long as disclosure is made to the principal first”).

114. *O'Hagan*, 521 U.S. at 655 n.6 (citing *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting)).

115. *Id.*

116. 15 U.S.C. § 78t-1 (2000).

117. See Langevoort, *Words from on High*, *supra* note 19, at 883 (discussing Chief Justice Burger’s dissenting opinion in *Chiarella*). Section 20A’s legislative history reveals that Congress intended the express private right of action for contemporaneous traders specifically to “overturn court cases which have precluded recovery for plaintiffs where the defendant’s violation is premised upon the misappropriation theory.” H. COMM. ON ENERGY AND COMMERCE, INSIDER TRADING AND SECURITIES FRAUD ENFORCEMENT ACT OF 1988, H.R. REP. NO. 100-910, at 26–27 (2d Sess. 1988), reprinted in 1988 U.S.C.C.A.N. 6043, 6063 [hereinafter ITSFEA HOUSE REPORT]. The Report’s reference to “court cases” was directed at *Moss v. Morgan Stanley & Co.*, 719 F.2d 5, 16 (2d Cir. 1983), where the Second Circuit refused to hold the defendants liable for insider trading because, although they breached a duty owed to the source of the information (their investment-bank employer), the defendants “owed no duty of disclosure to” the private plaintiffs. *Moss*, 719 F.2d at 16. Section 20A thus reflects an explicit congressional repudiation of *Moss*’s concern that liability to contemporaneous traders in misappropriation cases would grant “a windfall recovery simply to discourage tortious conduct by securities purchasers.” *Id.*

SEC in civil actions or the Department of Justice (“DOJ”) in criminal cases—rather than by private plaintiffs.<sup>118</sup>

The *O’Hagan* Court’s affinity for a fiduciary framework also fails to make sense as a matter of policy. As we have seen in *Chiarella*, Justice Powell used the fiduciary principle to circumscribe the class of defendants subject to Rule 10b-5 liability.<sup>119</sup> *Chiarella*’s fiduciary principle was thus inextricably tied to its policy goal of preventing insiders from exploiting the corporation’s information for personal profit. *O’Hagan* then widened the class of insider trading defendants to include certain outsiders who misuse confidential information in securities transactions. But the Court failed to provide a convincing rationale as to why that circle should be limited to those outsiders with a fiduciary-like nexus to the source. Given its concern with investor confidence and market integrity, the Court should have employed a broader theory that captured insider trading by non-fiduciary thieves and fiduciaries who disclose their intention to trade. Indeed, insider trading in those instances undermines market integrity and investor confidence to the same extent as secret trading by a fiduciary.<sup>120</sup> The Court would have served *O’Hagan*’s policy goals far better had it not endorsed a theory predicated entirely on a fiduciary relationship between the source and the trader.

The “deception by a fiduciary” paradigm did, however, provide a well-recognized route for reinstating *O’Hagan*’s conviction under Rule 10b-5. It also allowed the Court to complement its prior decisions by adhering to *Chiarella* and *Dirks*’s fiduciary rhetoric. In short, neither the government nor the Court needed another route in *O’Hagan* for sustaining liability. And because other routes were unnecessary, they were left unexplored.

### III. THE CASTING ASIDE OF FIDUCIARY PRINCIPLES

This Part of the Article explores how and why courts and the SEC often cast aside the fiduciary principles established in *Chiarella*, *Dirks*, and *O’Hagan*. Part A begins by examining the Supreme Court’s own willingness to depart from fiduciary principles in constructing both the classical and

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118. Although contemporaneous traders have an express right of action against persons who violate the federal securities laws by insider trading (or tipping), actions based solely on Section 20A are relatively infrequent, in part due to the narrow interpretation accorded the term “contemporaneous,” see NAGY, ET AL., *supra* note 28, at 522, and in part because Section 20A’s statutory remedy is limited to the insider trader’s profit or loss, which is further offset by any amount recovered by the SEC in disgorgement. See 15 U.S.C. § 78t-1(b). Enforcement of the federal prohibition of insider trading thus falls largely upon the government. *But see* NAGY, ET AL., *supra* note 28, at 131 (discussing Rule 10b-5’s heightened requirements for pleading scienter and noting that many actions against corporations for fraudulent misstatements or omissions also allege insider trading by company officials as a means of establishing a motive for the fraud).

119. See *supra* text accompanying notes 51–53

120. See Nagy, *supra* note 23, at 1251–65.

misappropriation theories of insider trading. Part B then focuses on recent insider trading decisions where adherence to the “deception by a fiduciary” paradigm would have produced rulings precisely opposite to those reached by the courts. The final Part analyzes SEC rulemaking in the insider trading area. It first examines Rule 10b5-1, an SEC rule that abandons fiduciary principles in instances where officers and directors have traded securities pursuant to pre-existing trading plans. It then turns to Rule 10b5-2, which extends the misappropriation theory beyond the context of a fiduciary’s self-serving use of material nonpublic information. A theme common to all three of these Parts is that insider trading involves the wrongful use of confidential information and Rule 10b-5 should be construed to prohibit such misuse. Although a majority of the Supreme Court has yet to endorse a doctrine expansive enough to reflect this view, a host of lower courts and the SEC have in effect concluded that the offense of insider trading focuses on a person’s wrongful use of confidential information, regardless of whether a fiduciary-like duty is breached.

#### A. THE SUPREME COURT’S FIDUCIARY FICTIONS

From a doctrinal perspective, the Court’s fiduciary foundation for insider trading liability under Rule 10b-5 was shaky from the start. At common law, most jurisdictions did not recognize the existence of a fiduciary relationship between an officer or director and the shareholders of a corporation. Rather, the majority of jurisdictions recognized that officers and directors owed fiduciary duties only to the corporation and not to its shareholders as such.<sup>121</sup> Thus, *Chiarella*’s statement about the fiduciary basis of the insider–shareholder relationship was drawn from the so-called “minority rule.”<sup>122</sup> And even those minority jurisdictions would not have extended the term fiduciary to mere employees or temporary agents of the corporations.<sup>123</sup>

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121. See LOUIS LOSS & JOEL SELIGMAN, FUNDAMENTALS OF SECURITIES REGULATION 939–43 (2004) (contrasting the so-called “majority rule”—which permitted traditional insiders to remain silent about material facts in transactions with shareholders on the theory that they owed fiduciary duties only to the corporation but not to the individual shareholder—with the so-called “special circumstances” doctrine—which recognized a duty to disclose when one party to a transaction had access to highly significant facts that were unknown to the other party—and the so-called minority rule—which recognized a fiduciary relationship between traditional insiders and the corporation’s shareholders and imposed disclosure duties on traditional insiders by virtue of their status).

122. See *infra* note 217 (citing common-law “minority rule” decisions imposing disclosure duties on officers and directors in face-to-face transactions with shareholders of the corporation).

123. See Fisch, *supra* note 34, at 193 (“Particularly in older cases, the position of a corporate insider has been analogized to that of a trustee” and observing that the law of trusts “imposes upon the trustee a duty of ‘utmost fairness’ to the beneficiary, including disclosure of all information known to the trustee”).



Minority jurisdictions placed two additional limitations on a shareholder's ability to prove deceit in a securities transaction with an insider. First, an insider's silence about material facts could be rendered fraudulent only in the context of a face-to-face transaction.<sup>124</sup> As noted previously, a plaintiff's detrimental reliance was essential for the court to find deceit. However, in securities transactions over a stock exchange, buyers and sellers generally remain anonymous to each other. Thus, a shareholder could not establish that he or she had relied on the insider's silence.<sup>125</sup> Yet the *Chiarella* Court cited numerous face-to-face transaction cases in support of a classical theory that was intended to apply to all securities trading, including anonymous market transactions.<sup>126</sup> Second, minority jurisdictions made clear that insiders owed fiduciary duties only to those investors with pre-existing relationships to the corporation.<sup>127</sup> *Chiarella* maintained, however, that it would be a "sorry distinction" to recognize fiduciary duties between a shareholder and an insider but not to recognize such duties in the very transaction where the person became a shareholder.<sup>128</sup> As Professor Victor Brudney observed, it is more than a little ironic "that the Supreme Court, in its efforts to narrow the scope of the disclosure requirements of Section 10(b), assumed, and in some sense may have furthered, broad local fiduciary law disclosure obligations of management and controllers."<sup>129</sup>

Fiduciary fiction was also essential to the Court's decision in *Dirks*, which recognized that tippees can, in some circumstances, inherit an insider's duty of disclosure.<sup>130</sup> To be sure, common-law courts may have barred a co-conspirator from profiting from the breach of an insider's duty to the corporation. But it is more than a stretch to say that this equitable

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124. See *Goodwin v. Agassiz*, 186 N.E. 659, 660 (Mass. 1933) (refusing to recognize the breach of a disclosure duty when the traditional insider's securities transactions were carried out over an anonymous stock exchange); see also Lawrence A. Hamermesh, *Calling Off the Lynch Mob: The Corporate Director's Fiduciary Disclosure Duty*, 49 VAND. L. REV. 1087, 1153 n.296 (1996) ("Research has not disclosed any case in which a stockholder selling in the market has successfully invoked [a] fiduciary disclosure duty, as opposed to Rule 10b-5, to recover compensatory damages from a director who concurrently bought stock.").

125. See Pritchard, *Agency Law*, *supra* note 51, at 25 ("Because of this anonymity in exchange markets, there can be no reliance on the insider's duty to disclose, and the insider cannot be said to have induced the trade.").

126. See *Chiarella v. United States*, 445 U.S. 222, 229-30 (1980) (citing *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 146 (1972) (face-to-face transaction involving fiduciary bank employees who purchased stock from their beneficiaries) and *Speed v. Transamerica Corp.*, 99 F. Supp. 808, 829 (D. Del. 1951) (face-to-face transaction involving majority shareholder and minority shareholder)).

127. See Pritchard, *Agency Law*, *supra* note 51, at 26 (noting that "the fiduciary obligation of corporate officers and directors . . . does not extend to prospective shareholders who may purchase their shares for the first time when an insider sells").

128. See *Chiarella*, 445 U.S. at 227 n.8 (quoting Judge Learned Hand's statement in *Gratz v. Claghton*, 187 F.2d 46, 49 (2d Cir. 1951), *cert. denied*, 341 U.S. 920 (1951)).

129. Victor Brudney, *O'Hagan's Problems*, 1997 SUP. CT. REV. 249, 255 n.15 (1997).

130. *Dirks v. SEC*, 463 U.S. 647, 655 (1983).

principle spawns a fiduciary duty of disclosure on the part of a tippee that would render his silence a fraud.<sup>131</sup> Even more difficult to justify under the common law is the notion that other tippees in a chain of communication function as fiduciaries whose silence is deceptive to shareholders.<sup>132</sup> Unlike an initial tippee who may have had direct contact with the insider–fiduciary, remote tippees are not only strangers to the corporation’s shareholders, they are often strangers to the insider as well.

Although fiduciary fictions were less central to the Court’s analysis in *O’Hagan*, the Court nonetheless painted fiduciary principles with an extremely broad brush. The critical determination in a misappropriation case is the presence of a fiduciary-like relationship that triggers a duty to disclose to the principal the fiduciary’s self-serving use of the confidential information. Yet, other than emphasizing the hallmarks of trust, loyalty, and confidentiality, the Court provided little analysis concerning fiduciary parameters.<sup>133</sup> In addition, *O’Hagan*’s creation of a safe harbor for fiduciaries who brazenly disclose to their principals their intention to trade makes little sense as a matter of fiduciary law.<sup>134</sup> As the Court itself recognized, absent permission, a fiduciary’s use of the principal’s information constitutes a clear violation of the duty of loyalty.<sup>135</sup> However, because the text of Section 10(b) extends only to conduct that is deceptive or manipulative, under Justice Ginsburg’s framework, full disclosure by the fiduciary to the source of the information must necessarily foreclose Rule 10b-5 liability.

Taken together, *Chiarella*, *Dirks*, and *O’Hagan* evidence a Supreme Court willing to stretch fiduciary principles to no small degree, when doing

131. See Fisch, *supra* note 34, at 210 (contending that “if the insider tips in breach of a duty of nondisclosure, it is illogical to find that this *duty of nondisclosure* is converted, in the hands of the tippee, into a *duty to disclose*”).

132. See Langevoort, *The Demise of Dirks*, *supra* note 69, at 24 (stating that it “is hard to see how a person who happens to be an unintended recipient of information becomes a participant with the original insider simply by the virtue of the receipt of that information”); see also Kathleen Coles, *The Dilemma of the Remote Tippee*, 41 GONZ. L. REV 181, 184 (2006) (contending that “the treatment of remote tippees tends to highlight the often disingenuous rationales underlying current regulation of insider trading”).

133. See Painter et al., *supra* note 35, at 191 (bemoaning that the misappropriation theory requires federal courts to embroil themselves in debates over the fiduciary duties of “accountants, appraisers, and investment bankers to their clients; doctors to their patients; taxi and limousine drivers to their passengers; newspaper columnists to their employers and their readers; professors to their students who work for law firms; priests, ministers, and rabbis to their parishioners; and so on”).

134. See Joseph McLaughlin, *O’Hagan: Some Answers, More Questions*, N.Y.L.J., July 1, 1997, at 1 (characterizing *O’Hagan*’s “disclosure to the source” exception as a “foul ball” in an otherwise “home run” decision and stating that “the damage [it] cause[s] will not be known for some time”); Painter et al., *supra* note 35, at 180 (noting in their aptly entitled article that “[o]nce the intent to trade is disclosed to the principal, the trading is legal under Section 10(b), no matter how strenuously the principal objects”).

135. See *supra* text accompanying note 107.

so facilitates a desirable policy outcome. But the Court's methodology may well have emboldened lower courts to approach new issues with similar results-oriented reasoning.

*B. LOWER COURTS AND THEIR DISREGARD OF THE  
"DECEPTION BY A FIDUCIARY" PARADIGM*

Although several lower courts have adhered strictly to the Supreme Court's dictate that insider trading liability must be predicated on deception by a fiduciary,<sup>136</sup> a growing number of courts simply disregard this fiduciary dictate when it forecloses liability against a defendant who has traded securities based on wrongfully obtained information. The first three Parts below explore decisions exemplifying this disregard. The final Part examines two insider trading decisions that ignored fiduciary principles in instances where their application would have established a violation of Rule 10b-5.

1. Liability for the Non-Fiduciary Thief

My initial critique of the *O'Hagan* decision predicted that an insider trading jurisprudence grounded in "deception by a fiduciary" would frustrate the government's ability to prosecute a wide range of insider trading cases.<sup>137</sup> I argued in particular that *O'Hagan*'s "recognized duty" requirement would create an unfortunate obstacle in cases involving the misappropriation of confidential information by a non-fiduciary.<sup>138</sup> One of the scenarios I envisioned involved a computer hacker who had purchased securities based on confidential information obtained through illegally accessing an issuer's database.<sup>139</sup> As a complete stranger to the source of the

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136. For examples of post-*O'Hagan* decisions dismissing insider trading charges based on the government's failure to establish a preexisting fiduciary relationship between the defendant and the source of the information or the issuer of the securities, see *infra* text accompanying notes 153–155 (discussing SEC v. Dorozhko, No. 07 Civ. 9606, 2008 WL 126612 (S.D.N.Y. Jan. 8, 2008)); see also *infra* text accompanying notes 249–256 (discussing United States v. Kim, 184 F. Supp. 2d 1006 (N.D. Cal. 2002)). The decision in *United States v. Cassese*, 273 F. Supp. 2d 481, 485 (S.D.N.Y. 2003), likewise reflects a strict adherence to the Supreme Court's fiduciary dictate. The court in *Cassese* refused to find a fiduciary-like relationship where, in the course of negotiations for a possible business combination, one company official had disclosed confidential information about a pending acquisition to an official from another company who then traded on that information. *Id.* at 488. The court emphasized that the company officials were "not inherent fiduciaries, but rather potential arms-length business partners . . . [who did not have] a long-standing relationship or . . . regularly share[] confidences." *Id.* at 486; see also SEC v. Talbot, 430 F. Supp. 2d 1029, 1049 (C.D. Cal. 2006) (granting summary judgment to the defendant because the SEC could not show he owed a fiduciary duty to the "originating source" of the information on which he traded), *rev'd*, 530 F.3d 1085, 1092–93 (9th Cir. 2008) (reversing the district court because the defendant's breach of a fiduciary duty owed to the "immediate source" of the information was sufficient to establish his liability under the misappropriation theory).

137. See Nagy, *supra* note 23, at 1251–64.

138. *Id.* at 1251–56.

139. *Id.* at 1253.

information, a computer hacker could not be said to have been entrusted with confidential information. Thus, because the deception essential to the misappropriation theory involved “feigning fidelity” to the source of the information, I concluded that *O’Hagan* would not extend to computer hacking or similar cases involving securities trading based on information misappropriated by a non-fiduciary.<sup>140</sup> Several other securities scholars have reached the same conclusion.<sup>141</sup>

In the decade since *O’Hagan*, the SEC has brought three insider trading cases charging computer hackers with violations of Rule 10b-5.<sup>142</sup> The SEC also initiated an enforcement action against what can be termed a cybersnoop: a defendant who had correctly guessed the password to a relative’s home computer and then used confidential information stored on the computer to purchase securities in a company targeted for an acquisition.<sup>143</sup> Although litigation remains pending in one of the cases, the penalties and equitable remedies imposed in the others would not have been possible absent the demise of fiduciary principles.

The SEC’s three computer-hacker cases involved remarkably similar facts. In each complaint, the SEC alleged that the defendants—all foreign nationals living abroad—had used phony passwords and other means of high-tech trickery to gain access to computer databases that stored confidential market-moving information about the securities issuers.<sup>144</sup> In one of the cases, the complaint further alleged that the defendants had used false identities and paperwork to open brokerage accounts in the United States.<sup>145</sup> Thus, in the SEC’s view, the defendants’ deceptive conduct in

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140. *Id.*

141. See Painter et al., *supra* note 35, at 181 (noting the government’s concession in *O’Hagan*’s oral argument that the misappropriation theory would not extend to trading by a thief); Robert A. Prentice, *The Internet and Its Challenges for the Future of Insider Trading Regulation*, 12 HARV. J.L. & TECH. 263, 297–98 (1999) (contending that absent acceptance of “nontraditional” arguments, insider trading based on hacked information “would have to be punished . . . via mail fraud, wire fraud, simple theft, or other comparable statutes”); Joel Seligman, *A Mature Synthesis: O’Hagan Resolves “Insider” Trading’s Most Vexing Problems*, 23 DEL. J. CORP. L. 1, 22 (1998) (stating that “an old fashioned burglar apparently need not fear Rule 10b-5” because “[h]e or she clearly violates the criminal law, but not a fiduciary or similar duty”). But see Robert Steinbuch, *Mere Thieves*, 67 MD. L. REV. 570, 594 (2008) (“*O’Hagan* and its progeny should not be read as requiring a fiduciary relationship under the misappropriation theory.”).

142. SEC v. Dorozhko, Litigation Release No. 20,349, 91 SEC Docket 2514 (Oct. 30, 2007), available at 2007 WL 3168187; SEC v. Blue Bottle Ltd. & Stokes (*Blue Bottle Lit. Rel. I*), Litigation Release No. 20,018, 2007 WL 580798 (Feb. 26, 2007); SEC v. Lohmus Haavel & Viisemann (*Lohmus Lit. Rel. I*), Litigation Release No. 19,450, 2005 WL 2861257 (Nov. 1, 2005).

143. SEC v. Stummer, Litigation Release No. 20,529, 93 SEC Docket 115 (Apr. 17, 2008), available at 2008 WL 1756796.

144. Dorozhko, 91 SEC Docket 2514; *Blue Bottle Lit. Rel. I*, 2007 WL 580798, at \*1; *Lohmus Lit. Rel. I*, 2005 WL 2861257, at \*1.

145. *Blue Bottle Lit. Rel. I*, 2007 WL 580798, at \*1.

acquiring the information was sufficiently connected to the defendants' securities transactions to warrant a finding of liability under Rule 10b-5.<sup>146</sup>

The district judges in the first two computer-hacker cases granted the relief requested by the SEC, but without issuing a published decision.<sup>147</sup> In the first case, the district judge granted the SEC's emergency request for a temporary restraining order, which, among other things, froze the defendants' assets and ordered the repatriation of funds taken out of the United States.<sup>148</sup> All of the defendants later settled with the SEC, consenting to a permanent injunction and agreeing to pay more than \$13 million in disgorgement and a combined penalty of \$2 million.<sup>149</sup> In the second case, the district judge granted the SEC's request to freeze assets and ordered the repatriation of funds;<sup>150</sup> the court later entered a default judgment ordering the payment of \$2.7 million in disgorgement and the imposition of an \$8 million penalty.<sup>151</sup> The SEC's release quotes the court's conclusion that the defendants violated Rule 10b-5 by their "'deceptive conduct in obtaining material, non-public information,' as well as by trading while in possession of that information."<sup>152</sup>

The defendant's fate in the third computer hacker case, *SEC v. Dorozhko*,<sup>153</sup> remains uncertain. After initially granting the SEC's motion to freeze the proceeds of the defendant's trades, the district judge ruled in his favor, reasoning, in a lengthy opinion, that she was "constrained to hold that [the defendant's] alleged 'stealing and trading' or 'hacking and trading' does not amount to a violation of § 10(b) and Rule 10b-5 because [the defendant] did not breach any fiduciary or similar duty 'in connection with' the purchase or sale of a security."<sup>154</sup> The district judge thus bucked the tide and refused to expand the offense of insider trading beyond the parameters

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146. *Dorozhko*, 91 SEC Docket 2514; *Lohmus Lit. Rel. I*, 2005 WL 2861257, at \*2.

147. *SEC v. Blue Bottle Ltd. & Stokes (Blue Bottle Lit. Rel. II)*, Litigation Release No. 20,095, 2007 WL 1238669, at \*1 (Apr. 27, 2007); *SEC v. Lohmus Haavel & Viisemann (Lohmus Lit. Rel. III)*, Litigation Release No. 20,134, 2007 WL 1574065, at \*1 (May 31, 2007); *SEC v. Lohmus Haavel & Viisemann (Lohmus Lit. Rel. II)*, Litigation Release No. 19,810, 2006 WL 2422653, at \*1 (Aug. 22, 2006); *Lohmus Lit. Rel. I*, 2005 WL 2861257, at \*1.

148. *Lohmus Lit. Rel. I*, 2005 WL 2861257, at \*1.

149. *Lohmus Lit. Rel. III*, 2007 WL 1574065, at \*1; *Lohmus Lit. Rel. II*, 2006 WL 2422653, at \*1. Although SEC rules do not allow defendants settling an enforcement action to simultaneously deny the allegations in the complaint, the rules do permit defendants to settle "without either admitting or denying" the charges against them. *NAGY ET AL.*, *supra* note 28, at 668. Unless otherwise specified, all of the settlements discussed in this Article involved defendants who neither admitted nor denied the SEC's charges.

150. *Blue Bottle Lit. Rel. I*, 2007 WL 580798, at \*1.

151. *Blue Bottle Lit. Rel. II*, 2007 WL 1238669, at \*1.

152. *Id.*

153. *SEC v. Dorozhko*, No. 07 Civ. 9606, 2008 WL 126612 (S.D.N.Y. Jan. 8, 2008).

154. *Id.* at \*2.

set out in *Chiarella*, *Dirks*, and *O'Hagan*.<sup>155</sup> The Second Circuit, however, quickly granted the SEC's request to stay the district court's decision to lift the asset freeze, pending the SEC's appeal from the district court's denial of its motion for a preliminary injunction.<sup>156</sup> Thus, the stock proceeds from the alleged computer hacking remain frozen notwithstanding the defendant's lack of a fiduciary relationship with the source of the information. The frozen assets coupled with the passage of time suggest that the Second Circuit may be predisposed to the government's position.

While not involving computer hacking as such, the SEC's case against the cybersnoop is equally at odds with *O'Hagan*'s "deception by a fiduciary" paradigm.<sup>157</sup> The SEC alleged that the defendant had fraudulently obtained material nonpublic information about an impending acquisition of a restaurant company and then used that information to trade securities.<sup>158</sup> Specifically, while a guest in the home of his sister and her husband, the defendant allegedly "snuck into [his] brother-in-law's bedroom office, where, secretly and without permission, he accessed his brother-in-law's bedroom office computer."<sup>159</sup> Having correctly guessed his brother-in-law's password, the defendant was able to obtain unauthorized access to a computer network that contained several confidential and nonpublic e-mails relating to an upcoming acquisition.<sup>160</sup> The SEC claimed that the defendant used this information to buy 5,500 shares in the restaurant company, which resulted in a profit of \$22,351 from the sale of the stock after the company announced the acquisition.<sup>161</sup> The defendant settled with the SEC, consented to the entry of an injunction under Section 10(b), and agreed to pay a total of \$46,386 in disgorgement, prejudgment interest, and a civil penalty in an amount equal to his profit.<sup>162</sup>

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155. See *id.* at \*1 ("To eliminate the fiduciary requirement now would be to undo decades of Supreme Court precedent, and rewrite the law as it has developed. It is beyond the purview of this Court to do so.").

156. Brief of Appellant, *SEC v. Dorozhko*, No. 08-0201-cv (2d Cir. Feb. 27, 2008), available at <http://www.docstoc.com/docs/1443629/SEC-v-Dorozhko> (granting the SEC's motion for a stay of the district court's decision to lift the asset freeze against the defendant).

157. *Stummer*, 93 SEC Docket 115 (announcing defendant's consent to the entry of a final judgment).

158. *Id.*

159. *Id.*

160. *Id.*

161. *Id.*

162. *Stummer*, 93 SEC Docket 115. Equally at odds with the fiduciary principle is the settlement obtained in *SEC v. Wilson*, Litigation Release No. 18,496, 81 SEC Docket 2572 (Dec. 9, 2003), available at 2003 WL 22907913. In that case, the defendant, while alone in the house of his daughter and son-in-law, found confidential documents belonging to the son-in-law while "searching for paper supplies in the pantry." *Id.* The confidential information pertained to the possible acquisition of the company employing his son-in-law. *Id.* Although it would have been difficult for the SEC to prove that the defendant had been "entrusted" with material nonpublic information, the defendant agreed to disgorge his trading profit of \$21,132, pay prejudgment

The SEC's victories in cases against computer hackers and cybersnoops have fueled the demise of fiduciary limitations in the law of insider trading. Yet strong arguments involving both policy and doctrine support the result. Indeed, the outcomes in all of the resolved cases—as well as the asset freeze order in the pending one—fully comport with the policy objectives set forth in *O'Hagan*. As the Court emphasized, “investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law.”<sup>163</sup> Moreover, as we shall see in the final Part of this Article, the SEC's litigation theory of “deceptive acquisition” of confidential information meets the textual demands of Rule 10b-5 and finds substantial support in recent Court precedents interpreting Rule 10b-5 outside the realm of insider trading.<sup>164</sup> But in contrast to the theories of insider trading liability endorsed by the Court in *Chiarella*, *Dirks*, and *O'Hagan*, a theory extending Rule 10b-5 liability to insider trading by computer hackers or cybersnoops would not have a fiduciary principle at its core.

## 2. Liability for the Brazen Fiduciary

Recall that *O'Hagan* involved a fact pattern in which an attorney kept secret from his law firm and its client his intention to use for personal profit their confidential tender-offer information, and the Court viewed this secret intent to trade as essential to its finding that he had engaged in deception within the meaning of Section 10(b).<sup>165</sup> The Court in *O'Hagan* went so far as to maintain that a fiduciary's full disclosure to the source of the information about an intent to trade would foreclose liability under the misappropriation theory.<sup>166</sup> I previously termed this type of insider trader a “brazen fiduciary,” and I predicted trouble for the government in any case where a defendant made such a brazen disclosure.<sup>167</sup> Although this safe harbor for brazen fiduciaries never made much sense as a normative matter, it was necessary to ensure that the securities trading constituted deception rather than merely the breach of a fiduciary duty.

Yet the First Circuit's recent decision in *SEC v. Rocklage*<sup>168</sup> essentially eviscerates *O'Hagan*'s dictate that a fiduciary's full disclosure to his principal forecloses Rule 10b-5 liability. The case involved sales of stock in a pharmaceutical company by the brother-in-law of the company's CEO, who

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interest, and pay a civil penalty of \$26,415—an amount equal to 1.25 times his profit. *Id.* The defendant also consented to an injunction against further violations of Section 10(b). *Id.*

163. *Id.*

164. *See infra* Part IV.B.1.

165. *See supra* text accompanying notes 90–93, 105–106.

166. *See supra* text accompanying note 107.

167. *See Nagy, supra* note 23, at 1256–59.

168. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

had received a tip from his sister (the CEO's wife).<sup>169</sup> Emphasizing the importance of confidentiality, the CEO had shared with his wife secret bad news involving the failure of a clinical drug trial, and discussed his belief that the news, when made public, would cause the company's stock price to drop significantly.<sup>170</sup>

In defending the charge of Rule 10b-5 liability for illegal tipping, the wife did not deny that she had shared this secret bad news with her brother, who then sold stock in the company to avoid substantial losses.<sup>171</sup> Rather, she contended that prior to tipping her brother, she informed her husband of her intent to do so, and thus did not deceive her husband within the meaning of Section 10(b).<sup>172</sup> Her defense, in fact, made very clear that she brazenly signaled her brother as to the imminent bad news notwithstanding her husband's strong objection.<sup>173</sup>

In straining to distinguish the wife's pre-trading disclosure from the brazen fiduciary scenario noted in *O'Hagan*, the First Circuit emphasized that the wife had obtained the confidential information through "deceptive acquisition."<sup>174</sup> That is, taking as true the SEC's contention that the wife had a "pre-existing" agreement with her brother to share information "with a wink and a nod,"<sup>175</sup> the court reasoned that she did absolutely nothing to correct her husband's mistaken understanding that she would keep the drug trial results confidential.<sup>176</sup> So, while her tipping of the information may not have been deceptive, the deceptive means by which she acquired the information from her husband was sufficient to trigger Rule 10b-5 liability. In the court's view, this stood in contrast to the facts of *O'Hagan*, where the defendant had acquired his information "legitimately."<sup>177</sup>

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169. *Id.* at 3–4.

170. *Id.*

171. *Id.* In addition to the CEO's wife and the CEO's brother-in-law, the third defendant in the case was a close friend and neighbor of the brother-in-law, who had sold stock in the pharmaceutical company after the brother-in-law relayed the information to him. *Id.* at 4.

172. *See id.* at 11 (noting the defendants' argument "that a pre-tip disclosure to the source of an intention to trade or tip completely eliminates any deception involved in the transaction"). The court further noted the defendants' argument "that *O'Hagan* put no qualifiers on what is meant by 'disclos[ure] to the source' of a plan to trade on nonpublic information, and so the SEC is not free to qualify the concept." *Id.*

173. *See Rocklage*, 470 F.3d at 11.

174. *Id.* at 12.

175. *Id.* at 4.

176. *Id.* at 3 (recounting the SEC's allegations that "Mrs. Rocklage initially concealed from her husband her prior agreement with her brother to tip him if she learned significant negative information about the company" and that "[s]he also concealed that she did not intend to maintain the confidentiality that her husband had reasonably understood to bind her").

177. *See id.* at 9. The court stated that "[a]rguably, the language in *O'Hagan* can be read to create a 'safe harbor' if there is disclosure to the fiduciary principal of an intention to trade on or tip *legitimately acquired* information." *Id.* at 12; *see also id.* (stating that "[u]nlike this case, *O'Hagan* was not a case which involved the deceptive acquisition of information").



Yet the court's understanding that James O'Hagan had acquired his information "legitimately" hardly seems consistent with the facts of that case. O'Hagan could be said to have deceived both his law firm and its client into entrusting him with confidential information about the client's plans to launch a tender offer for Pillsbury stock. That is, O'Hagan "feigned fidelity" to his partners at the law firm and thus "duped" them into believing that he would retain the confidentiality of their secrets. But had he fully disclosed to them his prior embezzlement of unrelated client funds and his desperate need for money to cover that crime,<sup>178</sup> O'Hagan's law-firm partners undoubtedly would have blocked his access to confidential business information. Thus, O'Hagan's overall scheme could be said to have involved both "deceptive acquisition" and deceptive trading. Viewed in this way, the factual distinction between O'Hagan's trading and the wife's tipping disappears. *O'Hagan's* statement that "full disclosure forecloses [Rule 10b-5] liability under the misappropriation theory"<sup>179</sup> should apply not only to O'Hagan's trading but also to the tipping and trading in *Rocklage*.

That is not to say, however, that *O'Hagan's* safe harbor for brazen fiduciaries should be preserved. A theory of Rule 10b-5 liability that would permit the prosecution of persons who have traded securities on the basis of wrongfully obtained information would far better serve *O'Hagan's* policy justifications for prohibiting insider trading.<sup>180</sup> Pursuant to such a theory, the *Rocklage* court's finding that the wife shared information contrary to her husband's strict instructions could have established the necessary element of wrongfulness. And her brother's trading on the basis of that wrongfully obtained information would have rendered both his trading and his sister's tipping a violation of Rule 10b-5. However, such a theory of Rule 10b-5 liability is analytically distinct from *O'Hagan's* theory of "deception by a fiduciary's silence."

### 3. Tippee Liability in the Absence of a Tipper's Personal Benefit

In contrast to *O'Hagan's* misappropriation theory, which focuses on a fiduciary's deception of the information's source, *Chiarella's* classical theory turns on a fiduciary's deceptive silence in securities transactions with a corporation's shareholders.<sup>181</sup> As we have seen, *Dirks* extended this theory to certain instances of tippee trading, holding explicitly that a tippee assumes a fiduciary duty to a corporation's shareholders only when the insider has disclosed confidential information to the tippee for a personal benefit.<sup>182</sup>

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178. See *supra* note 92 and accompanying text (discussing O'Hagan's conviction in state court for the theft of client funds).

179. United States v. O'Hagan, 521 U.S. 642, 655 (1997).

180. See *infra* Part IV.B.

181. See *supra* text accompanying notes 43–49.

182. See *supra* text accompanying notes 73–75.

*Dirks*'s focus on the tipper's motivation would seem to require a finding of liability on the part of a tipper before a court could impose tippee liability under Rule 10b-5. Yet, in *United States v. Evans*,<sup>183</sup> the Seventh Circuit held that a tippee may be found guilty of violating Rule 10b-5 even though his tipper had been acquitted of illegal tipping at a previous trial.<sup>184</sup> Once again, a court jettisoned fiduciary principles where the facts evidenced the use of improperly obtained confidential information.

The tippee-defendant in that case, Ryan Evans, allegedly used confidential information about upcoming mergers and tender offers to purchase stock in the subject companies.<sup>185</sup> The alleged tipper was a close friend of Evans who had worked as a financial analyst at Credit-Suisse First Boston.<sup>186</sup> At Evans's first trial, where prosecutors tried him and his tipper-friend jointly, the jury acquitted the friend on charges of conspiracy as well as for violations of Rule 10b-5.<sup>187</sup> The jury also acquitted Evans on the conspiracy charge, but it deadlocked on the charges of insider trading.<sup>188</sup> At Evans's re-trial, the jury found him guilty of violating Rule 10b-5.<sup>189</sup>

In its opinion affirming the jury's verdict, the Seventh Circuit explicitly acknowledged *Dirks*'s two pre-conditions for tippee liability under Rule 10b-5: "there must have been a breach of the insider's fiduciary duty" for a personal benefit, and "'the tippee knows or should know that there has been a breach.'"<sup>190</sup> The court, however, did not view the first jury's acquittal of the tipper-friend as dispositive to the issue of Evans's guilt.<sup>191</sup> The court reasoned that from the victim's perspective, the breach of an insider's duty of confidentiality was "equally damaging whether [the insider] acted willfully or negligently."<sup>192</sup> The court thus maintained that tippee liability would be appropriate in instances "[w]here an insider is duped into breaching her

183. *United States v. Evans*, 486 F.3d 315 (7th Cir. 2007).

184. *Id.* at 322.

185. *Id.* at 318–20.

186. *Id.*

187. *Id.* at 320.

188. *Evans*, 486 F.3d at 320.

189. *Id.*

190. *Id.* at 321–22 (quoting *Dirks v. SEC*, 463 U.S. 646, 660 (1983)).

191. *Id.* at 323–24. The court reasoned that:

Reviewing the jury's verdict and the evidence at trial . . . the jury concluded that [the tipper] had a duty of confidentiality as a corporate insider (derivatively through Credit Suisse), breached it by giving Evans the information as a gift, but did not act with the requisite level of intent nor enter into an actual agreement with Evans.

*Id.* at 323. The court also speculated that the jury might have found that the tipper "did not receive any benefit from giving out the information, even the benefit of a gift, if he did not think that he was violating clients' confidentiality." *Id.* This speculation was necessary because the court had to rule on the collateral estoppel effect of the verdicts in the first trial.

192. *Id.* at 323.

duty of confidentiality and the tippee who induces that breach willfully trades on the information, knowing its disclosure to be improper.”<sup>193</sup> The court concluded that “[w]here the tippee has a relationship with the insider and the tippee knows the breach to be improper, the tippee may be liable for trading on the ill-gotten information,” even if “the tipper [did not] know that his disclosure was improper.”<sup>194</sup>

To be sure, the Seventh Circuit’s reasoning supports the policy objectives highlighted in *O’Hagan*, namely, ensuring market integrity and fostering investor confidence. The jury concluded that Evans knew or was reckless in not knowing that his friend’s communication violated the duty of confidentiality that his friend owed to his investment-bank employer.<sup>195</sup> Thus, Evans was certainly trading on information obtained improperly through a breach of the duty of care. But if the friend did not, in fact, know that his disclosures of confidential information to Evans were improper, it is difficult to see how the friend could have breached the duty of loyalty for a personal benefit.<sup>196</sup> And without the finding of a breach of loyalty on the part of the tipper, it is difficult to see how Evans could have inherited a derivative duty of disclosure. The limitations imposed by *Dirks*’s requirement of a “personal benefit” would seem to forestall liability, although it is not surprising that policy considerations would sway a court to interpret Rule 10b-5 to find otherwise.

#### 4. The Debate over “Possession vs. Use”

Despite the longstanding acceptance of *Chiarella*’s classical theory of insider trading, there remained an important question that went unanswered for almost two decades: whether Rule 10b-5 obliges insiders to “disclose or abstain” from trading securities on all occasions when they are in possession of material nonpublic information or on only those occasions when insiders are affirmatively using that information in a securities transaction.<sup>197</sup> Often termed the “possession vs. use” debate,<sup>198</sup> this

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193. *Evans*, 486 F.3d at 323. The court further stated that “where a tippee, for example, induces a tipper to breach her corporate duty, even if the tipper does not do so knowingly or willfully, the tippee can still be liable for trading on the improperly provided information.” *Id.*

194. *Id.*

195. *Id.* at 323.

196. Because Evans’s friend was not a temporary insider in all of the companies in which Evans bought stock, some of the trades for which the jury convicted Evans would have been prosecuted under the misappropriation theory. However, courts generally apply *Dirks*’s requirement of a personal benefit in misappropriation cases, notwithstanding that *Dirks* was a case under the classical theory. See FERRARA ET AL., *supra* note 36, at 2-71 to -74.

197. See Donna M. Nagy, *The “Possession vs. Use” Debate in the Context of Securities Trading by Traditional Insiders: Why Silence Can Never Be Golden*, 67 U. CIN. L. REV. 1129, 1130 (1999).

198. See *United States v. Smith*, 155 F.3d 1051, 1066 (9th Cir. 1998) (referring to the “use-possession” debate), *cert. denied*, 525 U.S. 1071 (1999); see also Allan Horwich, *Possession Versus Use: Is There a Causation Element in the Prohibition on Insider Trading?*, 52 BUS. LAW. 1235 (1997)

controversy persisted for years without judicial attention because inside traders rarely acknowledge possessing material nonpublic information while simultaneously disaffirming having used it.

Given the centrality of fiduciary principles to the classical theory of insider trading, one would have expected to see extensive discussion of those principles once the “possession vs. use” debate was finally litigated. But in the two circuit-court decisions that addressed the question directly, *SEC v. Adler*<sup>199</sup> and *United States v. Smith*,<sup>200</sup> the courts essentially ignored the fiduciary dictate that was at the heart of *Chiarella*’s classical theory.<sup>201</sup> Both the Eleventh Circuit in *Adler* and the Ninth Circuit in *Smith* rejected the government’s arguments for a test of “knowing possession,” adopting instead a test of “use.”<sup>202</sup> Yet despite frequent citations to *Chiarella* and *Dirks*, neither court gave much attention to their fiduciary foundation.

One of the defendants in *Adler* was a director who had learned at a regularly scheduled board meeting that the company would be losing all, or a substantial portion, of its orders from one of its largest customers.<sup>203</sup> The director then sold, within a week of the meeting, a significant number of his previously owned shares of stock. The SEC contended that the director, as an insider, violated Rule 10b-5 because he traded in company stock while in possession of material nonpublic information that he failed to disclose to shareholders.<sup>204</sup> In the SEC’s view, the director’s failure to “disclose or abstain” defrauded the shareholders who had purchased his stock in ignorance of the corporation’s impending announcement of bad news.<sup>205</sup>

The director’s defense to Rule 10b-5 liability emphasized that he had not misused any material nonpublic information in his securities

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(the possession vs. use debate focuses on “whether there is a distinction between (i) affirmatively using material inside information to trade, and (ii) trading while in possession of material inside information but without making deliberate use of the information”).

199. *SEC v. Adler*, 137 F.3d 1325 (11th Cir. 1998).

200. *Smith*, 155 F.3d at 1051.

201. Prior to *Adler* and *Smith*, the most thorough judicial analysis of the “possession vs. use” issue was dicta in *United States v. Teicher*, 987 F.2d 112, 120–21 (2d Cir. 1993).

202. *Adler*, 137 F.3d at 1337; *Smith*, 155 F.3d at 1068–69.

203. *Adler*, 137 F.3d at 1328.

204. *Id.* at 1332.

205. See Brief of Appellant at 20–21, *Adler*, 137 F.3d 1325 (No. 96-6084), 1997 WL 33487156. The SEC maintained that:

When a corporate insider like [the director–defendant] has information relating to his company’s stock that he knows (or is reckless in not knowing) to be non-public and material and he trades in the company’s stock, he deceives the persons on the other side of his trades by not disclosing to them the information, whether or not he “uses” the information in his trading. This is because, even if the information is not a factor in his decision to trade, he knows that the persons on the other side of his trades are trading in ignorance of it.

*Id.* at 18.

transactions. Specifically, he presented rather compelling evidence that these stock sales “were not made as a result of any alleged material nonpublic information, but were part of a preexisting plan to sell [the] stock.”<sup>206</sup> Thus, the director contended that his lack of motive to personally profit from the use of material nonpublic information insulated him from Rule 10b-5 liability. Agreeing with the defendant’s argument, the Eleventh Circuit concluded that “mere knowing possession—i.e., proof that an insider traded while in possession of material nonpublic information—is not a *per se* violation” of Rule 10b-5.<sup>207</sup>

The Eleventh Circuit based its support of a “use” test on Section 10(b)’s textual requirement of a “manipulative or deceptive device or contrivance.”<sup>208</sup> In the court’s view, the element of deception could be satisfied only if the director actually used the material nonpublic information in his securities transaction.<sup>209</sup> It reasoned that:

When an insider trades *on the basis of* material nonpublic information, the insider is clearly breaching a fiduciary duty to the shareholders and deriving personal gain from the use of the nonpublic information. On the other hand, we do not believe that the SEC’s knowing possession test would always and inevitably be limited to situations involving fraud.<sup>210</sup>

The court thus adopted a view of fiduciary duty that essentially ignored the disclosure obligation on which the classical theory is premised.

The Ninth Circuit’s opinion in *Smith*, a criminal prosecution against an officer of the issuer, relied heavily on the reasoning in *Adler*.<sup>211</sup> However, instead of viewing the defendant’s “use” of material nonpublic information as a prerequisite to deception, the *Smith* court viewed the use of such

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206. *Adler*, 137 F.3d at 1328. The director-defendant presented evidence that his preexisting plans to sell the stock were made “in order to buy an eighteen wheel truck for his son’s business”; that he sold as soon as a 120-day lock-up on the stock had expired; that he sold only a small percentage of his shares in the corporation; and that he spoke with his broker more than a week before he learned the alleged material nonpublic information. *Id.* at 1328–29. The director presented further evidence that he pre-cleared his trades (as he was required to do) with the corporation’s general counsel. *Id.* at 1329.

207. *Id.* at 1337. The court maintained, however, that the SEC is entitled to a rebuttable inference of use based on facts demonstrating that an insider traded while in possession of material nonpublic information. *Id.* at 1337–38.

208. *Id.* at 1332.

209. *Id.*

210. *Adler*, 137 F.3d at 1332.

211. See *United States v. Smith*, 155 F.3d 1051, 1067–68 (9th Cir. 1998) (noting that the Eleventh Circuit in *Adler* was “the only court of appeals [that] squarely . . . consider[ed] the causation issue” and expressing agreement with *Adler*’s conclusion that “a ‘use’ requirement [was] more consistent with the language of § 10(b) and Rule 10b-5”); see also *id.* at 1068 (“Like our colleagues on the Eleventh Circuit, we are concerned that the SEC’s ‘knowing possession’ standard would not be—indeed, could not be—strictly limited to those situations actually involving intentional fraud.”).

information as a fact necessary to establish the insider's scienter.<sup>212</sup> The court reasoned that:

[I]f the insider merely possesses and does not use, the [insider and his purchaser or seller] are trading on a level playing field; if the insider merely possesses and does not use, *both* individuals are "making their decisions on the basis of incomplete information." It is the insider's use, not his possession, that gives rise to an informational advantage and the requisite intent to defraud.<sup>213</sup>

With this emphasis on Section 10(b)'s scienter requirement, the *Smith* court concluded that an "investor who has a preexisting plan to trade, and who carries through with that plan after coming into possession of material nonpublic information, does not intend to defraud or deceive; he simply intends to implement his pre-possession financial strategy."<sup>214</sup>

The *Adler* and *Smith* courts plainly viewed the wrongful use of material nonpublic information as the crux of the Rule 10b-5 violation. However, that view of insider trading adds a gloss missing from the classical theory articulated by Justice Powell in *Chiarella*. Indeed, the dictate that "a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him"<sup>215</sup> focuses specifically on the information that the insider possesses but the shareholder does not. Thus, in reading Rule 10b-5 to require a causal connection between the information and the securities trading, *Adler* and *Smith* overlooked *Chiarella*'s core: when a defendant stands in a fiduciary relationship to the shareholders with whom he is trading, his silence about material facts constitutes deception.<sup>216</sup> *Adler* and *Smith* also overlooked a host of common-law deceit decisions, which, consistent with the fiduciary principle, emphasized the shareholders' right to know the material facts possessed by the insider.<sup>217</sup>

212. See Roberta Karmel, *The Controversy of Possession Versus Use*, N.Y.L.J., Dec. 17, 1998, at 4-5.

213. *Smith*, 155 F.3d at 1068. Because *Smith* was a criminal proceeding, the court rejected the Eleventh Circuit's conclusion in *Adler* that proof of an insider's possession of material nonpublic information at the time of the trade entitles the government to an inference of use. *Id.* at 1069. Rather, taking no position on the SEC's burden in a civil case, the court held that Rule 10b-5 requires that the government "demonstrate that the suspected inside trader actually used material nonpublic information in consummating his transaction." *Id.* at 1069 & n.27.

214. *Id.* at 1068.

215. *Chiarella v. United States*, 445 U.S. 222, 227 (1980) (citing *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 911 (1961)).

216. *Id.* at 228; see also Nagy, *supra* note 197, at 1132.

217. See, e.g., *Van Schaack Holdings, Ltd. v. Van Schaack*, 867 P.2d 892, 897-98 (Colo. 1994) (emphasizing that "directors of a corporation and its controlling shareholders [must] act with an extreme measure of candor, unselfishness, and good faith in relation to remaining shareholders" and concluding that "this duty encompasses the obligation to fully disclose all material facts and circumstances surrounding or affecting a proposed transaction" (citations

But while *Adler* and *Smith* may have turned the classical theory's fiduciary principle on its head, the decisions nonetheless find strong support in the policy objectives underlying the decisions in both *Chiarella* and *Dirks*. As *Adler* and *Smith* emphasized, concerns that insiders may be unjustly enriched through trading on the corporation's information are implicated only on the actual use of confidential information in a securities transaction. The "use" test also responds to the Court's concern with the "'inherent unfairness involved where one takes advantage' of 'information intended to be available only for a corporate purpose and not for the personal benefit of anyone.'"<sup>218</sup>

The courts in *Adler* and *Smith* may well have viewed the classical theory's fiduciary principle as simply a means to the policy end of preventing insiders from misusing confidential corporate information. If so, they may have cast it aside because it was never a very principled principle.

### C. SEC INSIDER TRADING RULES

In August 2000, the SEC invoked its rulemaking authority under Section 10(b) to adopt two new insider trading rules.<sup>219</sup> Both rules responded to lower court rulings. That is, Rule 10b5-1 addressed the "possession vs. use" debate and responded to the decisions in *Adler* and *Smith*.<sup>220</sup> Rule 10b5-2 addressed the scope of the misappropriation theory and responded to the Second Circuit's decision in *United States v. Chestman*.<sup>221</sup> Although the SEC intended the two rules to clarify existing prohibitions under the classical and misappropriation theories, the SEC's

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omitted)); *Blakesley v. Johnson*, 608 P.2d 908, 915 (Kan. 1980) (maintaining that a minority shareholder "had a legal right on the facts in this case to rely upon [the majority shareholder] to make a full disclosure"); *Hotchkiss v. Fischer*, 16 P.2d 530, 535, 534 (Kan. 1932) (maintaining that "a director negotiating with a shareholder for purchase of shares acts in a relation of scrupulous trust and confidence" and concluding that "full and fair disclosure required . . . the furnishing of [all] information [in the director's possession]"); *Dawson v. Nat'l Life Ins. Co.*, 157 N.W. 929, 938 (Iowa 1916) (recognizing a cause of action for fraud in securities trading when a corporate officer fails to make "full disclosure of all facts bearing thereon known to such officer and unknown to the shareholder"); *Stewart v. Harris*, 77 P. 277, 281 (Kan. 1904) (holding that "before any director or managing officer . . . can rightfully purchase the stock of one not actively engaged in the management of its affairs, such director or managing officer must inform such stockholder of the true condition of the affairs of the corporation"); see also Elliott J. Weiss, *United States v. O'Hagan: Pragmatism Returns to the Law of Insider Trading*, 23 J. CORP. L. 395, 399 (1998) ("A shareholder who sold a corporation's stock to an insider in a face-to-face transaction had a right to expect that the insider, as a fiduciary, would disclose any material, nonpublic information that he possessed before effectuating the transaction.").

218. *Dirks v. SEC*, 463 U.S. 646, 654 (1983) (quoting *In re Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 43 S.E.C. 933, 936 (1968)).

219. 17 C.F.R. §§ 240.10b5-1, 10b5-2 (2008). See SEC Adopting Release, *supra* note 14, at 83,676.

220. See *supra* Part III.B.4.

221. *United States v. Chestman*, 947 F.2d 551 (2d Cir. 1991).

selective adherence to fiduciary principles has only exacerbated the confusion.

# 1. Rule 10b5-1 and Its Affirmative Defenses for “Preexisting Trading Plans”

Having lost the “possession vs. use” debate in *Adler* and *Smith*, the SEC did not relish the possibility of re-litigating this question in other circuits. Instead, it opted to resolve the issue through its rulemaking authority under Section 10(b). Rule 10b5-1 comes close to endorsing a “knowing possession” standard because it causes liability to turn on whether a person traded securities while “aware” of material nonpublic information. But the rule also reverses a longstanding SEC position. That is, in its release adopting the rule, the SEC explicitly acknowledged that an “absolute standard based on knowing possession, or awareness, could be overbroad in some respects” and that persons with certain trading plans formulated prior to any awareness of material nonpublic information should be able to trade under Rule 10b-5 with impunity.<sup>222</sup> Rule 10b5-1 therefore reflects the SEC’s concession (after many years of arguing otherwise) that the offense of insider trading involves the wrongful use of material nonpublic information and that fiduciary principles are only relevant insofar as they establish misuse.<sup>223</sup>

Rule 10b5-1 sets out a general principle that the “manipulative and deceptive devices” prohibited by Section 10(b) and Rule 10b-5 shall include, among other things, securities trading “on the basis of material nonpublic information . . . in breach of a duty of trust or confidence that is owed . . . to the issuer of that security or the shareholders of that issuer, or to any other person who is the source of the material nonpublic information.”<sup>224</sup> The rule then defines the phrase “on the basis of” to include securities trading by someone who “was aware of the material nonpublic information.”<sup>225</sup>

Had the SEC stopped there, Rule 10b5-1 would have squarely embraced the fiduciary principles set out in *Chiarella*, *Dirks*, and *O’Hagan*.<sup>226</sup> But the

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222. SEC Adopting Release, *supra* note 14, at 83,692; *see also* Allan Horwich, *The Origin, Application, Validity, and Potential Misuse of Rule 10b5-1*, 62 BUS. LAW. 913, 924–25 (2007) (“[T]he overall structure and rationale for the rule suggest that the SEC recognized that a ‘use’ test was the fairest one, even though explicit application of that standard was not something the SEC could support as a matter of policy.” (footnote omitted)).

223. In its Release proposing Rule 10b5-1, the SEC expressed the view that “[w]henever a person purchases or sells a security while aware of material nonpublic information *that has been improperly obtained*, that person has the type of unfair informational advantage over other participants in the market that insider trading law is designed to prevent.” Selective Disclosure and Insider Trading, Exchange Act Release No. 42,259 [1999–2000 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 86,228, at 82,860 (Dec. 20, 1999) [hereinafter SEC Proposing Release] (emphasis added).

224. 17 C.F.R. § 240.10b5-1(a).

225. *Id.* § 240.10b5-1(b).

226. *But see supra* notes 50, 98 (emphasizing that the Supreme Court has described the relevant duty as one of “trust and confidence”).



text of the rule goes on to set out three affirmative defenses to Rule 10b-5 liability, which, according to the SEC, address the situation in which “a person may reach a decision to make a particular trade without any awareness of material nonpublic information, but then come into possession of such information before the trade actually takes place.”<sup>227</sup> Recognizing that under a rigid “knowing possession” test Rule 10b-5 liability would attach, the SEC sought to specify those particular circumstances under which such securities trading would not be illegal. Accordingly, the rule’s affirmative defenses preclude liability when a person, before becoming aware of the material nonpublic information: (1) had entered into “a binding contract” to purchase or sell the security; (2) had provided instructions to another person to purchase or sell the security for the instructing person’s account; or (3) had adopted a “written plan” for trading securities.<sup>228</sup> Each of these three defenses also requires the person to demonstrate that such a contract, instruction, or plan either:

- (1) Specified the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold;
- (2) Included a written formula or algorithm, or computer program, for determining the amount of securities to be purchased or sold and the price at which and the date on which the securities were to be purchased or sold; or
- (3) Did not permit the person to exercise any subsequent influence over how, when, or whether to effect purchases or sales; provided, in addition, that any other person who . . . did exercise such influence must not have been aware of the material nonpublic information when doing so.<sup>229</sup>

The rule also strictly limits the availability of these affirmative defenses to circumstances in which the contract, plan, or instruction to trade is “entered into in good faith and not as part of a plan or scheme to evade the prohibitions of [the rule].”<sup>230</sup> Moreover, the rule makes clear that these affirmative defenses are available to both entities and natural persons.<sup>231</sup>

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227. See SEC Proposing Release, *supra* note 223, at 82,860; see also SEC v. Healthsouth Corp., 261 F. Supp. 2d 1298, 1322 (N.D. Ala. 2003) (“[I]t is a defense to an allegation of violation of Section 10b and Rule 10b5-1, if the person making the purchase or sale demonstrates that the purchase or sale that occurred was made pursuant to a plan.”).

228. 17 C.F.R. § 240.10b5-1(c)(1)(i)(A)(1)–(3).

229. *Id.* § 240.10b5-1(c)(1)(i)(B)(1)–(3).

230. *Id.* § 240.10b5-1(c)(1)(ii).

231. *Id.* § 240.10b5-1(c)(1), (2). As other commentators have observed, Rule 10b5-1’s application in criminal cases may be susceptible to challenge. See WANG & STEINBERG, *supra* note 14, at 4-124 (noting that “in criminal cases, the issue may arise whether Rule 10b5-1 violates the

Rule 10b5-1's affirmative defenses clash considerably with the fiduciary principle established in *Chiarella*. As we have seen, at least in those common-law jurisdictions recognizing a fiduciary relationship between the corporation's shareholders and its officers and directors, an insider would be liable for deceit if he remained silent about material facts in a transaction with a shareholder.<sup>232</sup> It would not have mattered whether the insider's decision to trade the corporation's securities had pre-existed his knowledge of that information. Rather, common-law cases emphasized both the shareholder's "right to know" the material nonpublic information possessed by the insider and the unfairness to the shareholder that resulted from the insider's decision to remain silent about the material facts.<sup>233</sup> And the Supreme Court's statement in *Chiarella* that "a corporate insider must abstain from trading in the shares of his corporation unless he has first disclosed all material inside information known to him" mirrors this common-law dictate.<sup>234</sup>

Why, then, did the SEC promulgate a "pre-existing trade plan" safe harbor that ignores its prior position and the underlying command of *Chiarella*? Once again, pragmatism has trumped doctrinal consistency with the fiduciary principle. Justice Powell intended the fiduciary principle to limit the category of defendants who could be liable for trading on the basis of material nonpublic information.<sup>235</sup> His policy goal was to prohibit insiders from profiting, directly or indirectly, from the misuse of confidential corporate information, and the fiduciary principle reflected in the *Restatement (Second) of Torts* provided him with the means to that end. But an absolute rule of full disclosure in securities transactions between insiders and shareholders would prohibit securities trading even if the decision to buy or sell the securities was made well in advance of the insider's awareness of confidential information. The affirmative defenses in Rule 10b5-1 allow officers and directors (and others) to prove that they did not use material nonpublic information in their transaction and, thus, establish that they did not misuse such information. The paradox is that Rule 10b-5 has traditionally broadened the protections against fraud and deceit that were available for securities investors under the common law, and the SEC has consistently advocated this broad reading.<sup>236</sup> Yet, at least in the context of one-on-one securities transactions between an insider and a shareholder, the common law of fraud and deceit would provide the shareholder with protection that is no longer available under Rule 10b-5.

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due process clause of the [Fifth] Amendment by placing the burden on the defendant to show that he or she did not in fact trade 'on the basis' of information of which he or she was aware").

232. See *supra* text accompanying note 44 and *supra* note 217.

233. See *supra* note 217.

234. *Chiarella v. United States*, 445 U.S. 222, 227 (1980).

235. See *supra* text accompanying notes 52–54.

236. See *infra* text accompanying notes 349–353.

Consider, for example, a director who, on March 1, personally solicits a shareholder to sell him 1,000 shares of stock in the corporation for \$10,000, with the sale to take place on March 31. At the time the director proposes this plan, he is not aware of any material information that is being withheld from the corporation's shareholders. Assume further that the shareholder agrees to the terms of the director's proposal and that plan is reduced to writing, though it does not constitute a binding contract. Under the common law, if the director came into possession of secret good news about the company over the ensuing month, that director would be obligated to share the good news with the shareholder prior to buying the stock.<sup>237</sup> He could not remain silent about the material facts and purchase the stock at the previously agreed to price. And if the director nonetheless completed the purchase without full disclosure of these new-found facts, the shareholder would have a cause of action for deceit.

Yet, under the affirmative defenses in Rule 10b5-1, that same director could execute that very same pre-existing trading plan without incurring liability under Rule 10b-5. Given the face-to-face nature of this transaction, this result seems anomalous. After all, these facts demonstrate a corporate shareholder's detrimental reliance on an insider's silence. But Rule 10b5-1 does not draw a distinction between trading plans developed in the context of one-on-one transactions and trading plans formed for transactions that will occur over anonymous securities markets.<sup>238</sup>

One could certainly make an argument that Rule 10b5-1's affirmative defenses for pre-existing plans are troubling only in the context of face-to-face securities transactions. Transactions over the NYSE or the NASDAQ do not involve situations where shareholders can demonstrate that they actually relied on an insider's silence. Now, however, we have a second paradox. As

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237. See cases cited *supra* note 217.

238. Rule 10b5-1's affirmative defenses may also have changed the result in *Jordan v. Duff & Phelps Inc.*, 815 F.2d 429 (7th Cir. 1987), a well-known decision by Judge Frank Easterbrook over a dissent by Judge Richard Posner. The case involved a former employee of Duff & Phelps who sued the company under Rule 10b-5 for repurchasing his stock without disclosing material nonpublic information relating to the possibility of a merger between the corporation and another firm. *Id.* at 433. The former employee asserted that had he known of the impending merger, he would have postponed his decision to retire, and thus would not have been obligated, pursuant to a buy-sell agreement, to surrender his stock at book value. *Id.* at 432-33. Viewing the employee's retirement decision as, in effect, an investment decision, the Seventh Circuit held that the company may have violated Rule 10b-5 by remaining silent and repurchasing the employee's shares when it owed him a fiduciary duty of disclosure. *Id.* at 437-39. Yet, had Rule 10b5-1 been in place, the company could have asserted an affirmative defense based on a "pre-existing" trade plan. That is, prior to its awareness of the possibility of a merger, the company had entered into a binding contract under which it was obligated to purchase all of the employee's shares at a specified price (book value) and at a specified time (the employee's resignation from the company). *Id.* at 432. Accordingly, pursuant to Rule 10b5-1, the company may have been entitled to remain silent while purchasing the shares from the uninformed seller.

Professor Louis Loss observed more than a decade before *Chiarella*: “it would be a strange rule of fiduciary conduct that permitted the fiduciary to hide behind a mass of agents for unnamed principals—which is essentially what a stock exchange is.”<sup>239</sup>

However, in all likelihood, the SEC did not intend Rule 10b5-1 to conform to the principle that insiders owe a fiduciary duty of disclosure in transactions with the corporation’s shareholders. Rather, the SEC promulgated Rule 10b5-1 in the wake of the developing consensus by courts and the SEC that insider trading involves the intentional misuse of confidential information. The insider who remains silent in the face of material facts acquired subsequent to the development of a trading plan may violate a disclosure obligation owed to a shareholder in a one-on-one transaction.<sup>240</sup> But that insider is not in any sense making use of improperly obtained information and is thus not engaging in illegal insider trading. Ironically, and circuitously, the policy goal sought by Justice Powell in *Chiarella* has now found its way into positive law.

## 2. Rule 10b5-2 and Its Application to Confidentiality Agreements

To determine the applicability of the misappropriation theory in the years leading up to *O’Hagan*, lower courts examined whether the source of the information and the person who traded (or tipped) had a fiduciary relationship or “similar relationship of trust and confidence.”<sup>241</sup> The *O’Hagan* Court said nothing about this relationship other than to characterize it as involving “trust and confidence” and “loyalty and confidentiality.”<sup>242</sup> In the wake of *O’Hagan*, many courts looked to the Second Circuit’s en banc decision in *United States v. Chestman*, which extensively analyzed the necessary elements of a fiduciary relationship or its “functional equivalent.”<sup>243</sup>

The *Chestman* court reversed an insider trading conviction under Rule 10b-5 because, in the majority’s view, the government did not sustain its burden of proving a fiduciary-like relationship between the tipper and the source of the information.<sup>244</sup> Although the tipper was married to the source,

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239. Louis Loss, *The Fiduciary Concept as Applied to Trading by Corporate “Insiders” in the United States*, 33 MOD. L. REV. 34, 47 (1970).

240. See *supra* note 217.

241. *United States v. Chestman*, 947 F.2d 551, 567 (2d Cir. 1991) (en banc) (citing *United States v. Carpenter*, 791 F.2d 1024, 1028–29 (2d Cir. 1986)), *aff’d by an equally divided Court*, 484 U.S. 19 (1987)); *SEC v. Materia*, 745 F.2d 197, 201 (2d Cir. 1984); *United States v. Newman*, 664 F.2d 12, 17–18 (2d Cir. 1981).

242. See *United States v. O’Hagan*, 521 U.S. 642, 652 (1997).

243. *Chestman*, 947 F.2d at 568.

244. *Id.* at 554. The Second Circuit also reversed the defendant’s conviction under the mail-fraud statute, 18 U.S.C. § 1341, but it affirmed his conviction under Rule 14e-3, an SEC rule that prohibits insider trading in the context of tender offers. *Id.* Rule 14e-3 is discussed at *supra* note 30.

and the information was imparted in confidence, the Second Circuit reasoned that “marriage does not, without more, create a fiduciary relationship”<sup>245</sup> and that “a fiduciary duty cannot be imposed unilaterally by entrusting a person with confidential information.”<sup>246</sup> Rather, as the Second Circuit saw it:

A fiduciary relationship involves discretionary authority and dependency: One person depends on another—the fiduciary—to serve his interests. In relying on a fiduciary to act for his benefit, the beneficiary of the relation may entrust the fiduciary with custody over property of one sort or another. Because the fiduciary obtains access to this property to serve the ends of the fiduciary relationship, he becomes duty-bound not to appropriate the property for his own use. . . . These characteristics represent the measure of the paradigmatic fiduciary relationship. A similar relationship of trust and confidence consequently must share these qualities.<sup>247</sup>

Other courts, following *Chestman*, emphasized that “[q]ualifying relationships are marked by the fact that the party in whom confidence is reposed has entered into a relationship in which he or she acts to serve the interests of the party entrusting him or her with such information.”<sup>248</sup>

One noteworthy decision relying on *Chestman*’s construction of the fiduciary-relationship requirement is *United States v. Kim*.<sup>249</sup> There, the court dismissed an indictment charging insider trading based on the misappropriation theory, despite the defendant’s explicit agreement to maintain the confidentiality of the information.<sup>250</sup> Both the defendant and the source of the information belonged to a local chapter of the Young Presidents Organization (“YPO”), a nationwide association of company presidents under the age of fifty.<sup>251</sup> YPO required club members to comply with a written “Confidentiality Commitment,” which the government alleged the defendant had violated by purchasing securities in a takeover target based on information shared during a YPO retreat.<sup>252</sup> The court, however,

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245. *Id.* at 568 (emphasizing that a “‘similar relationship of trust and confidence’ . . . must be the functional equivalent of a fiduciary relationship”).

246. *Id.* at 567.

247. *Id.* at 569.

248. *United States v. Falcone*, 257 F.3d 226, 234–35 (2d Cir. 2001). The *Chestman* view, however, was not universal. *See, e.g.*, *SEC v. Yun*, 327 F.3d 1263, 1272 (11th Cir. 2003) (addressing the misappropriation theory in the context of a spousal relationship and concluding that *Chestman* ignores “the many instances in which a spouse has a reasonable expectation of confidentiality”).

249. *United States v. Kim*, 184 F. Supp. 2d 1006 (N.D. Cal. 2002).

250. *Id.* at 1008.

251. *Id.*

252. *Id.*

disagreed with the government's view that club members had a special "fiduciary-like" relationship with each other.<sup>253</sup> Citing *Chestman*, the court emphasized that "the primary essential characteristic of the fiduciary relation is some measure of superiority, dominance, or control."<sup>254</sup> As the court saw it, the relationship among the YPO club members was "an equal relationship between peers" rather than a "relationship involving a degree of dominance."<sup>255</sup> Moreover, despite the government's urging, the existence of an explicit confidentiality agreement did not sway the court's decision. In the court's view, "[t]he agreement may memorialize a moral and ethical duty that members undertake, but it does not create a legal one."<sup>256</sup>

Rule 10b5-2 responded directly to what the SEC viewed as *Chestman*'s unduly narrow parameters and its failure to "sufficiently protect investors and the securities markets from the misappropriation and resulting misuse of inside information."<sup>257</sup> Adopted in August 2000, the rule bears the caption, "Duties of trust or confidence in misappropriation theory cases."<sup>258</sup> As its preliminary note explains, the rule provides a non-exclusive list of three situations in which a person has "a duty of trust or confidence" for purposes of the misappropriation theory.<sup>259</sup> These three situations include:

- (1) when the person receiving the information "agrees to maintain [that] information in confidence";
- (2) when the persons involved in the communication "have a history, pattern, or practice of sharing confidences" that results in a reasonable expectation of confidentiality; and

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253. *Id.* at 1011.

254. *Kim*, 184 F. Supp. 2d at 1011.

255. *Id.* at 1011–12. Although the court was correct in recognizing that *Chestman* referenced superiority, dominance, and control as characteristics of a fiduciary relationship, the *Chestman* court placed even greater emphasis on the fact that a fiduciary acts for "the benefit of another person, as to whom he stands in a relation implying and necessitating great confidence and trust on the one part and a high degree of good faith on the other part." *United States v. Chestman*, 947 F.2d 551, 568–69 (2d Cir. 1991) (citing BLACK'S LAW DICTIONARY 564 (5th ed. 1979)). The facts in *Kim*, however, failed to demonstrate that the defendant received the confidential information for the benefit of another. *See Kim*, 184 F. Supp. 2d at 1012 (observing that the communication of the confidential information "was completely gratuitous").

256. *Id.* at 1013. For a case involving highly similar facts to those in *Kim*, but reaching precisely the opposite result, see *SEC v. Kirch*, 263 F. Supp. 2d 1144, 1147–50 (N.D. Ill. 2003) (member of a business roundtable owed a "duty of loyalty and confidentiality" to a fellow member where there was an "express policy and understanding that such [nonpublic business] matters were indeed to be kept confidential"). The decisions in *Kim* and *Kirch* are difficult to reconcile and evidence the lack of clarity and consistency that has characterized insider trading law in the decade since *O'Hagan*.

257. SEC Proposing Release, *supra* note 223, at 82,863.

258. 17 C.F.R. § 240.10b5-2 (2008).

259. *Id.* at Preliminary Note.

(3) when the person receives such information from a spouse, parent, child or sibling, unless the person can show affirmatively, based on the particular facts and circumstances of that family relationship, that “he or she neither knew nor reasonably should have known that the person who was the source of the information expected that the person would keep the information confidential.”<sup>260</sup>

Accordingly, had Rule 10b5-2 been in place at the time of the defendants’ alleged violations, it may have changed the result in both *Chestman* and *Kim*: the husband-tipper in *Chestman* may have breached a duty owed to his wife pursuant to Rule 10b5-2(b)(3) and the defendant in *Kim* may have breached a duty owed to his fellow club member pursuant to Rule 10b-5(b)(1) and (2).<sup>261</sup>

Rule 10b5-2 affects the legal landscape in even more profound ways. Indeed, both Rule 10b5-2’s caption and its preliminary note rephrase the Supreme Court’s requirement of a fiduciary or similar relationship of “trust and confidence”<sup>262</sup> to one of “trust *or* confidence.”<sup>263</sup> This change from the conjunctive to the disjunctive extends the scope of the misappropriation theory considerably. To be sure, the terms “trust” and “confidence” are often used synonymously to describe reliance on the character or ability of someone to act in a right and proper way.<sup>264</sup> But as used in Rule 10b5-2, the term “confidence” may align more with an obligation of “confidentiality” than with obligations predicated on trust and loyalty. *O’Hagan*, however, made clear that it is the insider trader’s undisclosed breach of trust and

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260. *Id.* at § 240.10b5-2(b)(1)–(3). According to the SEC, “Rule 10b5-2 addresses the issue of when a breach of a family or other non-business relationship may give rise to liability under the misappropriation theory.” SEC Adopting Release, *supra* note 14, at 83,677. There is, however, nothing in the text of Rule 10b5-2 that forestalls its application to business relationships, and at least one court has made specific reference to the rule in that context. *See SEC v. Kornman*, 391 F. Supp. 2d 477, 488–89 (N.D. Tex. 2005) (rejecting defendant’s claim that his prospective role as an estate and tax planner to two corporate executives did not carry with it a fiduciary-like obligation to keep confidential their discussions about upcoming acquisitions and buyouts). *But see SEC v. Talbot*, 430 F. Supp. 2d 1029, 1061 n.91 (C.D. Cal. 2006) (maintaining that “Rule 10b5-2 was not intended to apply to business relationships”), *rev’d on other grounds*, 530 F.3d 1085, 1092–93 (9th Cir. 2008).

261. There is, of course, the possibility that the courts would have ruled to invalidate Rule 10b5-2 on the ground that it exceeded the SEC’s authority under Section 10(b). *See infra* note 268 (citing *Kim*’s statement questioning the validity of Rule 10b5-2(b)(1)); *see also* Ray J. Grzebielski, *Friends, Family, Fiduciaries: Personal Relationships as a Basis for Insider Trading Violations*, 51 CATH. U. L. REV. 467, 492 (2002) (questioning whether Rule 10b5-2 is “outside of the SEC’s authority under Rule 10b-5”).

262. *See supra* note 50 (noting *Chiarella*’s repeated use of the phrase “trust and confidence”); note 98 (noting *O’Hagan*’s repeated use of the phrase “trust and confidence”).

263. 17 C.F.R. § 240.10b5-2 (emphasis added).

264. *See* WEBSTER’S NINTH NEW COLLEGIATE DICTIONARY 275, 1268 (1990) (defining “confidence” as “faith or belief that one will act in a right, proper, or effective way” and “trust” as “assured reliance on the character, ability, strength, or truth of someone or something”).

loyalty—and not merely his breach of confidentiality—that constitutes the fraud under Rule 10b-5. As the Court stated, a “fiduciary who pretends loyalty to the principal while secretly converting the principal’s information for personal gain dupes or defrauds the principal.”<sup>265</sup>

The SEC’s expansion of liability under the misappropriation theory is most apparent in connection with Rule 10b5-2(b)(1), which encompasses situations in which “a person agrees to maintain information in confidence.”<sup>266</sup> This category dispenses entirely with the relational elements of trust and loyalty essential to *O’Hagan’s* reasoning. Thus, while Rule 10b5-1’s second and third categories may substantially dilute fiduciary principles,<sup>267</sup> the rule’s first category simply dispenses with those principles altogether.<sup>268</sup>

Consider, for example, recent insider trading enforcement actions initiated by the SEC in connection with so-called private investment in public equity (“PIPE”) transactions. A PIPE transaction is a form of stock offering often used by small public companies to raise a substantial amount of capital quickly. Those who purchase securities in these offerings do so expecting to resell their shares into the public trading markets after the issuer’s subsequent filing of a resale registration statement with the SEC. Such participants—often hedge funds—typically enter into private-placement contracts that include a confidentiality agreement. In fact, confidentiality with respect to the PIPE transaction is necessary to preserve the issuer’s exemption from the Securities Act’s registration provisions.<sup>269</sup>

Where the SEC believes a purchaser in a PIPE transaction has used its informational advantage to trade securities in the public markets (typically through the practice of short-selling), the SEC has not hesitated to bring charges of illegal insider trading. Most of these cases have settled, with the defendants consenting to injunctions under Section 10(b) and the payment

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265. *United States v. O’Hagan*, 521 U.S. 642, 643 (1997).

266. 17 C.F.R. § 240.10b5-2(b)(1).

267. See David Mills & Robert Weisberg, *Corrupting the Harm Requirement in White Collar Crime*, 60 STAN. L. REV. 1371, 1433–35 (2008) (discussing Rule 10b5-2 and observing that, based on the need to maintain the integrity of the markets, the rule extends “to cases in which there is no real fiduciary duty, in the sense that that term has been used over the years”).

268. See Grzebielski, *supra* note 261, at 492 (discussing Rule 10b5-2 and contending that “[a]n agreement to keep information confidential in an arm’s length negotiation establishes no fiduciary relationship or like relationship of trust and confidence”); D. Gordon Smith, *The Critical Resource Theory of Fiduciary Duty*, 55 VAND. L. REV. 1399, 1422 (2002) (noting that “extending securities liability to any relationship where ‘a person agrees to maintain information in confidence’ extends the boundaries well beyond fiduciary relationships” (quoting 17 C.F.R. § 240.10b5-2(b)(1)); see also *United States v. Kim*, 184 F. Supp. 2d 1006, 1015 (N.D. Cal. 2002) (“[A]n express agreement can provide the basis for misappropriation liability only if the express agreement sets forth a relationship with the hallmarks of a fiduciary relationship.”).

269. See Bruce Hiler et al., *Enforcement Pipeline: Insider Trading, Unregistered Sales, and the Hedging of Private Investment in Public Equity*, 39 SEC. REG. & L. REP. (BNA) 952 (June 18, 2007).



of disgorgement, prejudgment interest, and substantial penalties.<sup>270</sup> To be sure, shorting the issuer's stock can be quite profitable because the PIPE transaction has a dilutive effect on the value of the company's existing shares. But one would be hard pressed to say that a purchaser in a PIPE transaction is "feigning fidelity" to the securities issuer when that purchaser also sells short the issuer's shares. The typical relationship between the parties to a PIPE transaction is at arm's-length,<sup>271</sup> and an agreement not to share information with third parties is analytically distinct from a fiduciary obligation not to take advantage of that information in one's personal securities trading over a stock exchange.<sup>272</sup> Accordingly, a confidentiality

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270. See SEC v. Ladin, Litigation Release No. 20,784, 2008 WL 4629527 (Oct. 20, 2008) (hedge fund analyst consented to a \$700,000 payment, of which the analyst paid roughly \$317,000, to settle charges that he caused his fund to short stock based on information pertaining to an upcoming PIPE transaction); SEC v. Deephaven Capital Mgmt., LLC & Lieberman, Litigation Release No. 19,683, 87 SEC Docket 2726 (May 2, 2006), *available at* 2006 WL 1152605 (hedge fund adviser and portfolio manager consented to \$5.8 million payment to settle charges including insider trading in 19 PIPE offerings); SEC v. Langley Partners, L.P., Litigation Release No. 19,607, 2006 WL 623053, at \*2 (Mar. 14, 2006) (three hedge funds and their portfolio manager consented to a \$16 million payment to settle allegations that included illegal insider trading in advance of the public announcement of seven PIPE transactions); SEC v. Shane, Litigation Release No. 19,227, 85 SEC Docket 1300 (May 18, 2005), *available at* 2005 WL 1172243 (hedge fund manager agreed to pay more than \$1 million to settle charges that she had shorted stock while under a specific agreement to keep a PIPE transaction confidential); see also SEC v. Pollet, Litigation Release No. 19,984, 2007 WL 257645, at \*1 (Jan. 29, 2007) (managing director of a broker-dealer consented to a \$150,000 payment and a permanent bar from association with a broker-dealer to settle allegations that he sold short for proprietary accounts "the securities of ten public companies after receiving confidential non-public information that these entities were either engaged in, or were contemplating engaging in, 'PIPE' financings"). In four of those transactions, the broker-dealer served as the PIPE issuers' investment banker and was thus a "temporary insider" of the issuer. But, in the other six transactions, the broker-dealer was itself the purchaser in the private placement and thus stood in an arm's-length relationship with the issuer. See Complaint at 1-2, *Pollet*, 2007 WL 257645, *available at* <http://www.sec.gov/litigation/complaints/2007/comp19984.pdf>.

271. See Hiler et al., *supra* note 269, at 957 (stating that PIPE transactions are "often the subject of vigorous negotiations involving, among other issues, the purchase price of the shares, the representations and warranties of the parties, and the anticipated registration of the shares" and that "[t]hese negotiations, and this arm's length relationship often continue up to and through the date deals are signed, and even thereafter"). Cf. *Walton v. Morgan Stanley & Co.*, 623 F.2d 796, 798 (2d Cir. 1980) (holding that when two corporations' management were "at all times responsible for different interests, and . . . had no relationship to each other before or other than in the acquisition discussions," they "must be presumed to have dealt, absent evidence of an extraordinary relationship, at arm's length").

272. The SEC's recent enforcement action against Mark Cuban, the high-profile owner of the NBA's Dallas Mavericks franchise, charges insider trading in an instance where the recipient of PIPE-related information sold his stock in the issuer after declining an offer to purchase additional shares in the private placement. See Complaint ¶ 1, SEC v. Mark Cuban, Litigation Release No. 20,810 (Nov. 17, 2008), *available at* <http://www.sec.gov/litigation/complaints/2008/comp20810.pdf>. According to the SEC's complaint, the CEO of Momma.com had extracted from Cuban a promise of confidentiality prior to offering him an opportunity to participate in the PIPE transaction. See *id.* ¶¶ 12-14. Thus, in the SEC's view, Cuban had "breached a duty of trust or confidence that he owed to Momma.com" when he later sold his

agreement, standing alone, should be insufficient to establish the requisite fiduciary-like relationship.<sup>273</sup> Yet, at least two courts have accepted the SEC's position that Rule 10b5-2(b)(1) allows the prosecution of cases under the misappropriation theory based solely upon a trader's agreement to maintain the confidentiality of a PIPE transaction.<sup>274</sup>

The highly publicized Goldman Sachs Treasury Desk trading scandal provides yet another example of the misappropriation theory's extension to confidentiality agreements.<sup>275</sup> The material nonpublic information at issue involved the U.S. Department of Treasury's announcement on October 31, 2001 that it was suspending issuance of thirty-year bonds.<sup>276</sup> Peter Davis, a political consultant hired by Goldman Sachs, learned of the suspension in a private press briefing where a Treasury official instructed the attendees that they were to embargo the announcement until 10:00 a.m. that morning.<sup>277</sup> According to the government, many years earlier, Davis had agreed

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entire stake in the company (600,000 shares) on the basis of material nonpublic information concerning the upcoming PIPE offering. *Id.* ¶ 26. Cuban is contesting the SEC's charges. *See* Kara Scannell & Leslie Eaton, *Cuban Lays Out Defense to Insider-Trade Charges*, WALL ST. J., Nov. 19, 2008, at C3 (reporting that Cuban claims there was "no agreement to keep information confidential"). The validity of Rule 10b5-2's "trust or confidence" phraseology may well become an important issue in the litigation.

273. *See* *Paul v. Judicial Watch, Inc.*, 543 F. Supp. 2d 1, 6 (D.D.C. 2008) (noting that "the mere existence of a contract does not create a fiduciary duty"; but that a plaintiff must show that the parties "extended their relationship beyond the limits of the contractual obligations to a relationship founded upon trust and confidence"); *Steele v. Isikoff*, 130 F. Supp. 2d 23, 36 (D.D.C. 2000) ("[T]he mere existence of a contractual relationship is ordinarily insufficient to give rise to a fiduciary duty."); *Church of Scientology Int'l v. Eli Lilly & Co.*, 848 F. Supp. 1018, 1028 (D.D.C. 1994) ("[W]hether there exists a fiduciary relationship is a fact-intensive question, involving a searching inquiry into the nature of the relationship, the promises made, the type of services or advice given and the legitimate expectations of the parties.").

274. *SEC v. Lyon*, 529 F. Supp. 2d 444, 452 (S.D.N.Y. 2008) (emphasizing the complaint's allegations that the private-placement materials "required investors to keep the information conveyed in connection with [PIPE] offerings confidential" and refusing to dismiss charges of insider trading because the SEC alleged specific facts "that plausibly support its claim that a confidential relationship arose between defendants and those four PIPE issuers"). In *SEC v. Mangan*, 598 F. Supp. 2d 731, 733 (W.D.N.C. 2008), the district court initially denied defendant's motion to dismiss the SEC's charges that the defendant had violated Rule 10b-5 by short selling stock while aware of the PIPE transaction. However, the court subsequently granted the defendant's motion for summary judgment, concluding that under the facts of the case, the information about the PIPE transaction was immaterial as a matter of law. *Id.* at 737. Moreover, in *SEC v. Kornman*, 391 F. Supp. 2d 477, 489–90 (N.D. Tex. 2005), the court cited Rule 10b5-2(b)(1) and refused to dismiss insider trading charges, in part because the SEC's complaint cited memoranda evidencing defendant's agreement to keep the relevant information confidential.

275. *See generally* *SEC v. Davis*, Litigation Release No. 18,322, 81 SEC Docket 2952 (Sept. 4, 2003), available at 2003 WL 23303550 (outlining the Treasury Desk trading scandal); Gregory Zuckerman, *Goldman Says It Got Early Word of Plan to End Sale of Long Bond*, WALL ST. J., Nov. 12, 2001, at C1 (same).

276. *Davis*, 81 SEC Docket 2952.

277. *Id.*

explicitly that he would preserve the confidentiality of any embargoed information learned through his attendance at press conferences.<sup>278</sup> Yet, at 9:35 a.m., Davis shared this information with John Youngdahl, a Senior Economist in Goldman's Global Economics Group.<sup>279</sup> Youngdahl then informed several traders at Goldman's Treasury Desk, who acted quickly to purchase \$84 million in thirty-year bonds for the firm's proprietary account.<sup>280</sup> Both Youngdahl and Davis pled guilty to criminal insider trading charges,<sup>281</sup> and the SEC obtained settlements resulting in injunctive relief and substantial monetary penalties.<sup>282</sup> The SEC also entered into a settlement with Goldman Sachs whereby the firm agreed to a censure and the payment of almost \$10 million in disgorgement, prejudgment interest, and civil penalties.<sup>283</sup>

Rule 10b5-2's extension of the misappropriation theory to breaches of a confidentiality agreement has contributed to the demise of fiduciary principles in the law of insider trading. And while *O'Hagan's* policy justifications may support liability for the wrongful use of such confidential information, *O'Hagan's* fiduciary-based framework militates against it.

#### IV. A LOOK TO THE FUTURE

The analysis in Parts II and III of this Article reveals an insider trading jurisprudence that has shifted almost full circle: starting as one where unequal access to information triggered a disclosure obligation under Rule

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278. *Id.*

279. Kip Betz, *Ex-Goldman VP Given 33 Months in Insider Trading Case Over Long-Bond Tip*, 36 Sec. Reg. & L. Rep. 709, 709 (2004).

280. *Davis*, 81 SEC Docket 2952.

281. *See Betz, supra* note 279 (reporting Youngdahl's sentencing).

282. *See Davis*, 81 SEC Docket 2952 (announcing Davis's agreement to pay \$149,598 in disgorgement and penalties); SEC v. Davis, Litigation Release No. 18,453, 81 SEC Docket 1938 (Nov. 12, 2003), *available at* 2003 WL 22671043 (announcing Youngdahl's agreement to pay a penalty of \$240,000).

283. *See Davis*, 81 SEC Docket 2952. In a related enforcement action, the SEC has alleged that Davis also shared material nonpublic information about the Treasury's bond suspension with Joseph Nothern, a bond portfolio manager for MFS Investment Management in Boston, Massachusetts. *In re* Mass. Fin. Servs. Co., Investment Advisers Act Release No. 2165, 80 SEC Docket 2940 (Sept. 4, 2003), *available at* 2003 WL 22056989. Although MFS agreed to a settlement with the SEC, *see id.*, Nothern is litigating the Rule 10b-5 charges filed against him. *See SEC v. Nothern*, 400 F. Supp. 2d 362, 367 (D. Mass. 2005) (granting SEC's motion to strike defendant's affirmative defense of estoppel). Nothern has filed a motion for summary judgment based on a number of grounds, including that Davis did not owe a fiduciary duty to the Treasury Department, even if Davis had promised confidentiality as a precondition to his access to the briefing. *See Defendant's Memorandum in Support of His Motion for Summary Judgment*, SEC v. Nothern, 400 F. Supp. 2d 362 (D. Mass. 2005) (No. 105CV10983), 2008 WL 3342729. Nothern is also challenging the validity of Rule 10b5-2 insofar as the rule expands the fiduciary parameters set out in *Chiarella*, *Dirks*, and *O'Hagan*. *See id.* (maintaining that "the SEC lacks the power to interpret Rule 10b-5 in a manner inconsistent with the language of § 10(b) itself").

10b-5; then to one where the disclosure obligation was predicated on a fiduciary relationship between the parties to the securities transaction; next to one where the disclosure obligation was predicated on *either* a fiduciary relationship between the trading parties *or* between the trader-tipper and the source of the information; and finally, to one where the Rule 10b-5 violation now often turns on the wrongful use of material nonpublic information, regardless of whether a fiduciary-like duty has been breached. This latest jurisprudential shift has occurred in the wake of *O'Hagan* and is reflected in lower court decisions and SEC settlements imposing Rule 10b-5 liability outside of the “deception by a fiduciary” paradigm as well as in decisions holding that it is the insider’s affirmative use of material nonpublic information, and not merely the possession of such information, that violates Rule 10b-5. The latest shift is further evidenced by Rule 10b5-1’s affirmative defenses for insiders with “pre-existing” trading plans and Rule 10b5-2’s application to persons who merely agree to maintain the confidentiality of shared information.

The insider trading law that has evolved over the last decade promotes the policy objectives highlighted in the Supreme Court’s decisions: it prevents insiders from “exploiting [the corporation’s] information for their personal gain,”<sup>284</sup> and it fosters “investor confidence” and “market integrity” by ensuring that both insiders and outsiders are unable “to capitalize on nonpublic information through the purchase or sale of securities.”<sup>285</sup> However, the lack of a clear and consistent theory of insider trading liability compromises the government’s ability to achieve these objectives in prosecutions that fall outside of the “deception by a fiduciary” paradigm. The contradictions and confusion in the jurisprudential landscape also make Rule 10b5-1 and Rule 10b5-2 vulnerable to challenge in litigation.

The final part of this Article proposes three alternatives to the hodgepodge of theories, rules, and decisions that form the basis of today’s insider trading law. First, Congress could disentangle the offense of insider trading from Rule 10b-5 and define the conduct that would be subject to prosecution. Second, courts could reach beyond *O'Hagan* and explicitly recognize Rule 10b-5 liability in instances where material nonpublic information has been acquired deceptively, regardless of whether the trader and the source had a fiduciary-like relationship. A third possibility would be for courts to embrace a “fraud on investors” theory similar to the one proposed by Chief Justice Burger in his *Chiarella* dissent. Under such a theory, Rule 10b-5 liability for insider trading would turn on whether a securities trader failed to disclose to investors wrongfully obtained material nonpublic information. Although a statutory definition would be the best alternative, judicial acceptance of alternative theories of Rule 10b-5 liability

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284. SEC v. Dirks, 463 U.S. 646, 659 (1983).

285. United States v. O'Hagan, 521 U.S. 642, 652 (1997).

would at least move the law of insider trading in a more positive and consistent direction.

#### A. A STATUTORY DEFINITION FOR INSIDER TRADING

Unlike the explicit statutory prohibitions against insider trading that exist in most other countries with developed securities markets,<sup>286</sup> the law of insider trading in the United States is essentially judge-made, turning on whether such trading is deceptive under Rule 10b-5. Although a direct federal prohibition could take any number of forms,<sup>287</sup> the form that would best reflect the outcomes in recent cases, as well as the affirmative defenses and prohibition set forth in SEC rules, would be a statute prohibiting securities transactions based on “wrongfully obtained information.”

Ironically, the prohibition of securities trading based on wrongfully obtained information almost became law in the late 1980s when Congress was seeking to toughen the regulation and enforcement of insider trading.<sup>288</sup> In fact, Congress considered a statutory prohibition in connection with two monumental legislative efforts: the Insider Trading Sanctions Act of 1984 (“ITSA”),<sup>289</sup> which authorized the SEC to seek court-ordered civil monetary penalties of up to “three times the profit gained or loss avoided” from illegal trading or tipping;<sup>290</sup> and the Insider Trading and Securities Fraud Enforcement Act of 1988 (“ITSFEA”),<sup>291</sup> which extended ITSA’s civil penalty provision to “controlling persons”<sup>292</sup> and provided contemporaneous traders with an express private right of action for illegal tipping or trading.<sup>293</sup> ITSFEA also raised the maximum criminal penalties for willful violations of Exchange Act provisions and rules from a fine of \$100,000 and/or five years in prison, to a fine of \$1 million and/or ten years

286. See Marc I. Steinberg, *Insider Trading Regulation—A Comparative Analysis*, 37 INT’L LAW. 153, 162 (2003) (“[C]ountries abroad have adopted detailed and specific legislation defining the parameters of the insider trading proscription.”).

287. See Painter et al., *supra* note 35, at 221–23 (discussing a host of legislative proposals, including an “equality of access” approach advocated by Professor Joel Seligman; a “ban on trading based on ‘unerodable informational advantages,’” as recommended by Professor Victor Brudney; and an approach that “focuses on the duties of insiders to the market,” as recommended by Professor Jill Fisch).

288. See generally Thomas W. Joo, *Legislation and Legitimation: Congress and Insider Trading in the 1980s*, 82 IND. L.J. 575 (2007).

289. Insider Trading Sanctions Act of 1984, Pub. L. No. 98-376, 98 Stat. 1264 (1984) (codified as amended in scattered sections of 15 U.S.C.).

290. Exchange Act § 21A(a), 15 U.S.C. § 78u-1(a) (2000).

291. Insider Trading and Securities Fraud Enforcement Act of 1988, Pub. L. No. 100-704, 102 Stat. 4677 (1988) (codified as amended in scattered sections of 15 U.S.C. § 78).

292. See 15 U.S.C. § 78u-1(b)(1). Pursuant to this provision, the SEC, under specified circumstances, may seek a penalty against a person who, “at the time of the violation, directly or indirectly controlled the person who committed such violation.” *Id.* § 78u-1(a)(1)(B).

293. *Id.* § 78t-1.

in prison.<sup>294</sup> Rather than expressly prohibiting the offense of insider trading, Congress, on both occasions, merely enhanced the penalties without defining the conduct.<sup>295</sup>

Much could be gained, however, from dusting off ITSA and ITSFEA's legislative history, and in particular, Senate Bill 1380, a proposed bill entitled the "Insider Trading Proscriptions Act of 1987."<sup>296</sup> Senate Bill 1380 was introduced by Senators Donald Riegle and Alfonse D'Amato based on recommendations by a committee of securities-law practitioners headed by Harvey Pitt,<sup>297</sup> who many years later became Chair of the SEC. The bill, as it was later reconciled with alternative versions submitted by the SEC,<sup>298</sup> proposed adding a new Section 16A to the Exchange Act, making it unlawful:

[F]or any person, directly or indirectly, to purchase, sell or cause the purchase or sale of, any security, while in possession of material, nonpublic information relating thereto (or relating to the market therefor), if such person knows (or recklessly disregards) that such information has been obtained wrongfully, or that such purchase or sale would constitute a wrongful use of such information.<sup>299</sup>

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294. Insider Trading and Securities Fraud Enforcement Act § 4. The legislative history reveals that the increase in "the maximum jail term is an explicit congressional statement of the heightened seriousness with which insider trading and other securities fraud offenses should be viewed," and that Congress "expects that raising the ceiling will increase the certainty of substantial prison sentences." ITSFEA HOUSE REPORT, *supra* note 117, at 18. In 2002, these maximum criminal penalties were again increased with the enactment of the Sarbanes-Oxley Act, Pub. L. No. 107-204, § 1106, 116 Stat. 745, and Section 32(a) of the Exchange Act, 15 U.S.C. § 78ff(a), currently provides for fines of not more than \$5 million and/or imprisonment of not more than twenty years. *See supra* note 29.

295. *See* NAGY ET AL., *supra* note 28, at 519, 521 (noting that through "artful wording," the civil penalty provisions in Section 21A and the express private right of action in Section 20A apply to persons who are found to have violated the Exchange Act or any rule thereunder by "purchasing or selling a security while in possession of material, nonpublic information").

296. S. 1380, 100th Cong., 1st Sess. (1987), *reprinted in* FERRARA ET AL., *supra* note 36, app. C.

297. Harvey L. Pitt & Karen L. Shapiro, *Securities Regulation by Enforcement: A Look at the Next Decade*, 7 YALE J. ON REG. 149, 227-28 (1990).

298. To be sure, the SEC had long opposed any effort to enact a statutory prohibition of insider trading. *See* H.R. REP. No. 98-355, at 14 (1983), *reprinted in* 1984 U.S.C.C.A.N. 2274, 2287 (emphasizing the SEC recommendation that "any effort to define insider trading would result in . . . a rule that leaves gaping holes"). But in the latter half of 1987, the SEC grudgingly endorsed a legislative effort, in part because it feared that the Supreme Court would reject the misappropriation theory that had been embraced by the Second Circuit. *See* FERRARA ET AL., *supra* note 36, app. D, at 6-14 (reprinting the SEC's initial proposal); *see also* Roberta S. Karmel, *Outsider Trading on Confidential Information—A Breach in Search of a Duty*, 20 CARDOZO L. REV. 83, 100 (1998) (describing the SEC's fluctuating opposition to a statutory definition).

299. S. 1390 ("Reconciliation Draft," dated November 19, 1987), *reprinted in* Symposium: *Defining Insider Trading*, Appendix, 39 ALA. L. REV. 337 app. at 554 (1988).

The reconciled version of Senate Bill 1380 would have further provided that:

For the purposes of this subsection, such trading while in possession of material, nonpublic information is wrongful only if such information has been obtained by, or its use would constitute, directly or indirectly, (A) theft, bribery, misrepresentation, espionage (through electronic or other means) or (B) conversion, misappropriation, or a breach of any fiduciary duty, any personal or other relationship of trust and confidence, or any contractual or employment relationship.<sup>300</sup>

Congress, however, ultimately decided against any direct statutory prohibition because, in its view, “the court-drawn parameters of insider trading have established clear guidelines for the vast majority of traditional insider trading cases, and . . . a statutory definition could potentially be narrowing, and in an unintended manner facilitate schemes to evade the law.”<sup>301</sup>

The statutory prohibition in Senate Bill 1380 is generally viewed as a relic of history. Yet it is striking how closely that prohibition aligns with the jurisprudence—or at least the results—in the litigated cases and SEC settlements discussed in Part III. The statutory proposal is also consistent with Rules 10b5-1 and 10b5-2. In many ways, then, Congress attained what it sought in deflecting the definitional issue to the SEC and the courts. Congress’s evasiveness, however, has come at the cost of clarity, consistency, and legitimacy.

If Congress believes that insider trading is an offense that merits substantial monetary penalties and stiff prison sentences—and the penalty provisions in ITSA and ITSFEA confirm that it does—then it should confront the definitional issue head on, with the proposal in Senate Bill 1380 as a logical starting place. As one of Senate Bill 1380’s sponsors once emphasized, the “‘I know it when I see it standard’ is totally unacceptable.”<sup>302</sup> That indictment was valid in 1988, and it continues to ring true today as courts and the SEC struggle to apply the classical and misappropriation theories to conduct that lies outside of the “deception by a fiduciary” paradigm.

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300. *Id.*

301. ITSFEA HOUSE REPORT, *supra* note 117, at 11. However, had the Supreme Court rejected the validity of the misappropriation theory in *Carpenter v. United States*, 484 U.S. 19 (1987), *see supra* note 86, Congress likely would have been dissatisfied with the “court-drawn” parameters, and Senate Bill 1380 may well have been enacted into law. *See* Joo, *supra* note 288, at 612 (maintaining that the “perceived need” for Senate Bill 1380 abated “when the Supreme Court decided *Carpenter* late in 1987”).

302. 133 CONG. REC. 16,393 (1987) (statement of Sen. Alfonse D’Amato).

## B. ALTERNATIVE THEORIES OF INSIDER TRADING UNDER RULE 10b-5

Notwithstanding periodic rumblings from members of Congress,<sup>303</sup> the likelihood of a statutory prohibition of insider trading is remote. The offense of insider trading has long been viewed as a species of fraud under Rule 10b-5, and in the absence of a Supreme Court decision reinvigorating the fiduciary limitations in *Chiarella*, *Dirks*, and *O'Hagan*, Congress will likely remain content with the results reached by lower courts and the SEC, at least in the aggregate. Thus, the practical challenge going forward lies with devising a theory of insider trading liability where the deceptive breach of a fiduciary duty is no longer essential to the finding of fraud under Rule 10b-5.

## 1. Rule 10b-5 Liability Premised on the Deceptive Acquisition of Confidential Information

One way to add a modicum of clarity and consistency to the law of insider trading would be for courts to embrace a new theory premised on the deceptive acquisition of confidential information. This new theory of insider trading liability under Rule 10b-5 could function as a third alternative to the classical and misappropriation approaches. To be sure, the First Circuit started down this road in *SEC v. Rocklage*,<sup>304</sup> but the *Rocklage* court failed to make clear that a theory of deceptive acquisition is analytically distinct from the misappropriation theory endorsed in *O'Hagan*.<sup>305</sup> Indeed, a theory of deceptive acquisition could support liability in any case where confidential information was acquired through deceptive means, even in the absence of a fiduciary-like relationship between the trader and the source. Such a theory has firm roots in the text of Section 10(b) and Rule 10b-5, which extend broadly to encompass all deceptive devices and contrivances used in connection with securities trading. And while fiduciary principles have been central to the Supreme Court's view of Rule 10b-5 liability for insider trading, the plain language of Section 10(b) and Rule 10b-5 command no such limitation.<sup>306</sup>

The Supreme Court's recent decision in *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.*<sup>307</sup> provides compelling support for a new theory

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303. See Richard Hill, *Hedge Funds, Senior Senators Take Shots at the SEC*, 38 Sec. Reg. & L. Rep. (BNA) 2050 (Dec. 11, 2006) (reporting that Senator Arlen Specter was preparing a bill that would seek to prohibit insider trading directly).

304. *SEC v. Rocklage*, 470 F.3d 1 (1st Cir. 2006).

305. See *supra* text accompanying notes 174–177.

306. See Linda Chatman Thomsen, Dir., Div. of Enforcement, U.S. Sec. & Exch. Comm'n, Remarks Before the Australian Securities and Investments Commission 2008 Summer School: U.S. Experience of Insider Trading Enforcement (Feb. 19, 2008), available at <http://sec.gov/news/speech/2008/spch021908lct.htm> (emphasizing that “duty is not what the statute requires. Duty is a subset of the statutory requirement of deception”).

307. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761 (2008).



of insider trading liability premised on the deceptive acquisition of confidential information. The Court in *Stoneridge* reviewed a decision by the Eighth Circuit, which narrowly construed Section 10(b) and Rule 10b-5 to apply only to “misstatements, omissions by one who has a duty to disclose, and manipulative trading practices.”<sup>308</sup> The Supreme Court, however, unanimously rejected this construction, with both the majority and the dissenting Justices in agreement that “[c]onduct itself can be deceptive” under Section 10(b).<sup>309</sup> *Stoneridge* therefore affirms the government’s ability to pursue defendants who engage in deceptive conduct in connection with securities trading, even if that conduct does not involve misstatements or omissions by one who has a fiduciary-like duty to disclose.

A theory of “deceptive acquisition” would plug a few of the gaps left open by the fiduciary-based theories of insider trading liability previously endorsed by the Supreme Court. First, the theory could provide for liability in certain misappropriation cases where the securities trader lacks any pre-existing relationship with the source of the information, such as securities trading based on hacked information. Hacking into a computer to obtain information for securities trading typically involves acts that may be viewed as “deceptive.” As the SEC has argued, computer hackers employ “electronic means to trick, circumvent, or bypass computer security in order to gain unauthorized access to computer systems, networks, and information stored or communicated therein, and to steal such data.”<sup>310</sup> Moreover, federal law characterizes computer hacking as “fraud,” and an act of fraud necessarily involves an act of deception.<sup>311</sup> Although it is the computer system or network that permits the unauthorized access,<sup>312</sup> the computer is a mere conduit in the deceptive scheme that a hacker perpetrates on the

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308. *Id.* at 769 (quoting *In re Charter Commc’ns, Inc., Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006)).

309. *Id.* at 769, 775 (Stevens, J., dissenting) (characterizing the Eighth Circuit’s holding as “incorrect,” and noting that the Court “correctly explains why the statute covers nonverbal as well as verbal deceptive conduct”).

310. SEC v. Dorozhko, No. 07 Civ. 9606, 2008 WL 126612, at \*8 (S.D.N.Y. Jan. 8, 2008) (quoting the Posthearing Memorandum of Law in Support of Plaintiff Securities and Exchange Commission’s Motion for Preliminary Injunction and other Equitable Relief and in Opposition to Defendant Dorozhko’s Motion to Dismiss at 9, *Dorozhko*, 2008 WL 126612 (No. 107CV09606)).

311. *Id.* (noting the SEC’s citation to the Computer Fraud and Abuse Act, 18 U.S.C. § 1030(a)(4) (2000), which provides that whoever “knowingly and with intent to defraud, accesses” a computer covered by the Act “without authorization, or exceeds authorized access, and by means of such conduct furthers the intended fraud and obtains anything of value” shall be subject to punishment as provided for in the Act).

312. See Floyd Norris, *Make Big Profits Illegally (and Maybe Keep Them, Too)*, N.Y. TIMES, Feb. 15, 2008, at C1 (reporting a question posed by Second Circuit Judge Sonia Sotomayor during the SEC’s successful oral argument on its motion to stay the district judge’s decision to lift the asset freeze).

corporation whose security system he breaches.<sup>313</sup> And the hacker's deception would be "in connection with" the subsequent securities transactions because the hacking and the purchases of the issuer's stock are part of a single scheme, which is not complete until the securities purchases are made.

As we have seen, arguments based on a defendant's "deceptive acquisition" of confidential information have been met with mixed success in SEC prosecutions against alleged computer hackers for insider trading.<sup>314</sup> Although the SEC obtained the relief it requested in two cases,<sup>315</sup> a district court rejected the SEC's position in the third computer-hacker case, and the case is now under consideration by the Second Circuit.<sup>316</sup> But the district court lacked the benefit of the Supreme Court's guidance in *Stoneridge*, and its view that "a breach of a fiduciary duty of disclosure is a required element of any 'deceptive' device under § 10(b)" was precisely the view that all of the Justices rejected in *Stoneridge*.<sup>317</sup>

In addition to securities trading based on hacked information, the "deceptive acquisition" theory could extend Rule 10b-5 liability to other scenarios in which a person obtains confidential information through lies or other means of trickery, regardless of the existence of a fiduciary-like relationship. The deceptive acquisition theory thus provides a justification for the results reached in some of the litigated cases and SEC settlements discussed in Part III. Consider, for example, a friend who "duplicates" another into revealing material nonpublic information that he then uses in a securities transaction. This scenario may well be what the Seventh Circuit had in mind in *United States v. Evans*<sup>318</sup> when it upheld the tippee's criminal

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313. See *United States v. Cherif*, 943 F.2d 692, 696 (7th Cir. 1991) (affirming defendant's conviction for federal mail fraud and wire fraud, and holding that every time the defendant had used his improperly retained key card to gain entry into the bank that formerly employed him, the defendant "in effect, falsely represented that he was a bank employee entitled to be in the bank"). Cherif's unlawful entry enabled his misappropriation of material nonpublic information pertaining to the bank's clients, which he then used to trade securities. *Id.* The court thus regarded the electronic device reading Cherif's key card as a conduit in the deceptive scheme that defrauded the bank. *Id.* The SEC also brought civil charges under Rule 10b-5 against Cherif for insider trading. See *SEC v. Cherif*, 933 F.2d 403, 405 (7th Cir. 1991) (affirming the district court's preliminary injunction against Cherif). The decision, however, rested on the court's conclusion that as a former employee, Cherif continued to owe the bank fiduciary duties, even after the bank terminated his employment. See *id.* at 411-12.

314. See *supra* notes 147-156 and accompanying text.

315. *SEC v. Lohmus Haavel & Viisemann*, Litigation Release No. 20,134, 2007 WL 1574065 (May 31, 2007); *SEC v. Blue Bottle Ltd. & Stokes* (*Blue Bottle Lit. Rel. II*), Litigation Release No. 20,095, 2007 WL 1238669 (Apr. 27, 2007).

316. See *SEC v. Dorozhko*, No. 07 Civ. 9606, 2008 WL 126612, at \*1 (S.D.N.Y. Jan. 8, 2008) (discussed *supra* text accompanying notes 142-156).

317. *Id.* at \*8.

318. *United States v. Evans*, 486 F.3d 316, 323 (7th Cir. 2007).

conviction notwithstanding the previous acquittal of his tipper–friend.<sup>319</sup> Moreover, as we saw in *Rocklage*,<sup>320</sup> a wife deceptively acquires information from her husband when she fails to reveal a prior agreement to share his company’s information with her brother.<sup>321</sup> Another example of “deceptive acquisition” is one suggested by Professor Donald Langevoort, who hypothesizes a situation in which a person tricks another into leaving a business meeting in order to access confidential file folders left on the table.<sup>322</sup> Cybersnoops may also incur liability under this theory if they gained access to the computer through deception.<sup>323</sup>

Yet, a theory of insider trading liability premised on the deceptive acquisition of confidential information has its own limitations, and thus some of the gaps left open by the Court’s fiduciary-based theories will remain. One can imagine any number of scenarios where a trader obtains confidential information through outright theft, but where the theft is accomplished without any act of deception. Had a passing stranger stolen the papers in Professor Langevoort’s example while the owner had left the room to take a phone call, the information would not have been “deceptively acquired.” Had the owner been held up at gunpoint and robbed of the papers, the information would not have been deceptively acquired. Moreover, the deceptive acquisition theory would not extend to Rule 10b5-2 cases involving the breach of a confidentiality agreement, unless a defendant harbored an intent to breach the agreement at the time the confidential information was acquired.<sup>324</sup> Such hyper-factual distinctions are necessary because the theory turns on the deceptive means by which confidential information is acquired.

The deceptive acquisition theory is also vulnerable to the criticism repeatedly lodged by many scholars at the misappropriation theory endorsed in *O’Hagan*: that the theory is pretextual because it allows Rule 10b-5 to “catch” unfairness to investors without having to characterize that unfairness as fraud.<sup>325</sup> Under both theories, the sources of the

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319. See *supra* text accompanying notes 193–194 (discussing the court’s reference to an insider who is “duped into breaching her duty of confidentiality”).

320. SEC v. Rocklage, 470 F.3d 1 (1st Cir. 2006).

321. *Supra* text accompanying notes 174–177.

322. See LANGEVOORT, INSIDER TRADING, *supra* note 14, § 6:14.

323. See *supra* text accompanying notes 147–152 (discussing the SEC’s case against cybersnoops).

324. Cf. *Wharf (Holdings) Ltd. v. United Int’l Holdings, Inc.*, 532 U.S. 588, 597 (2001) (holding that a secret intention not to honor securities options amounted to deceit in connection with the sale of the options).

325. See Nagy, *supra* note 23, at 1275–76; see also Kimberly D. Krawiec, *Fairness, Efficiency, and Insider Trading: Deconstructing the Coin of the Realm in the Information Age*, 95 NW. U. L. REV. 443, 471–72 (2001) (noting that “it has been argued that the misappropriation theory, explicitly adopted by the Supreme Court in *O’Hagan*, is a mere pretext by the Commission, with the concurrence of the federal courts, to evade *Chiarella*’s limitations).

information—and not securities investors—are deceived by the defendant's conduct. Yet, under both theories, it is insider trading's impact on the securities market and the confidence of investors that provides the rationale for the Rule 10b-5 prohibition.

The charge of pretext can be avoided if courts were to recognize that a fraud on investors occurs when wrongfully obtained information is used in a securities transaction. Moreover, as compared with the classical and misappropriation theories, or with an approach based on a defendant's deceptive acquisition of information, the "fraud on investors" theory would encompass a broader range of cases.

## 2. Rule 10b-5 Liability Premised on a "Fraud on Investors"

In the absence of an express statutory prohibition, Chief Justice Burger's "fraud on investors" theory of Rule 10b-5 liability provides a starting point for the best approach to the problem of insider trading.<sup>326</sup> Like the other members of the *Chiarella* Court, Chief Justice Burger focused his Rule 10b-5 analysis on the propriety of a trader's silence about material nonpublic information in a securities transaction.<sup>327</sup> But unlike the majority in *Chiarella*, the Chief Justice did not regard the existence of a fiduciary relationship as essential to the duty to speak.<sup>328</sup> Rather, in his view, a duty to speak could arise any time that a securities trader used an informational advantage obtained through misappropriation.<sup>329</sup> Thus, under Chief Justice Burger's theory, the marketplace traders harmed by *Chiarella*'s insider trading were also the parties defrauded under Rule 10b-5.

To support his view that Rule 10b-5 imposes liability for a securities trader's silence about unlawfully obtained information, Chief Justice Burger looked to the common law. Specifically, he quoted the distinguished torts scholar Professor Page Keeton, who had long before observed that "[a]ny time information is acquired by . . . an illegal act it would seem that there should be a duty to disclose that information."<sup>330</sup> The Chief Justice read Rule 10b-5 to encompass and build upon this duty, concluding that "a

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326. See Langevoort, *supra* note 19, at 883 (expressing a preference for a Rule 10b-5 theory based on "a duty to disclose misappropriated information to other marketplace traders"); Nagy, *supra* note 23, at 1287–1310.

327. See *Chiarella v. United States*, 445 U.S. 222, 240 (1980) (Burger, C.J., dissenting) ("I would read § 10(b) and Rule 10b-5 to encompass and build on this principle: to mean that a person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.").

328. *Id.* ("[The] provisions [of Rule 10b-5] reach any person engaged in any fraudulent scheme.").

329. *Id.* (maintaining that the common-law rule of caveat emptor did not apply in instances where "an informational advantage is obtained, not by superior experience, foresight, or industry, but by some unlawful means").

330. *Id.* (emphasis omitted) (quoting Page W. Keeton, *Fraud—Concealment and Non-Disclosure*, 15 TEX. L. REV. 1, 25–26 (1936)).

person who has misappropriated nonpublic information has an absolute duty to disclose that information or to refrain from trading.”<sup>331</sup>

My prior research on disclosure duties under the common law bolsters the analysis in the Chief Justice’s dissent.<sup>332</sup> At least two courts have explicitly recognized a duty to disclose wrongfully obtained information,<sup>333</sup> and the duty is reflected in an illustration to the *Restatement (Second) of Contracts*.<sup>334</sup> A duty to disclose wrongfully obtained information also reinforces the common law’s concerns with economic efficiency. That is, unlike a “parity of information” rule, which could operate to discourage diligent research and legitimate searches for information, a duty to disclose wrongfully obtained information disallows only those informational advantages that serve “no useful function except [the trader’s] own enrichment at the expense of others.”<sup>335</sup> The sparseness of case law supporting the duty to disclose wrongfully obtained information should not be surprising. As scholars have argued recently, such cases may settle early in the litigation process because the defendants are “unsympathetic (having violated the law or committed a tort). . . . [and] might fear that courts will treat them more harshly.”<sup>336</sup>

Recent Supreme Court decisions reveal conflicting views concerning the role of common law in shaping the elements of claims based on Section 10(b) and Rule 10b-5. In the *Stoneridge* case decided just last term, five Justices subscribed to the view that “Section 10(b) does not incorporate common-law fraud into federal law.”<sup>337</sup> Yet, only three terms before, in *Dura*

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331. *Id.* at 237 n.21 (citation omitted).

332. *See* Nagy, *supra* note 23, at 1288–96.

333. *See id.* at 1290–93 (discussing *Mallon Oil Co. v. Bowen/Edwards Assocs.*, 965 P.2d 105 (Colo. 1998) and the British case of *Phillips v. Homfray*, 6 Ch. App. 770 (1871)). The transactions at issue in both *Mallon Oil* and *Phillips* involved real estate where the buyer obtained an informational advantage through an illegal trespass on the seller’s property. *See id.* at 1290–91.

334. *See id.* at 1290 n.317 (citing RESTATEMENT (SECOND) OF CONTRACTS § 161 illus. 11 (1979)). Illustration 11 provides that “[Buyer] A learns of [the] valuable mineral deposits from trespassing on [vendor] B’s land . . . . A’s non-disclosure is equivalent to an assertion that the land does not contain valuable mineral deposits, and this assertion is a misrepresentation.” RESTATEMENT (SECOND) OF CONTRACTS § 161 illus. 11 (1979).

335. *Chiarella v. United States*, 445 U.S. 222, 241 (1980) (Burger, C.J., dissenting). *See* Nagy, *supra* note 23, at 1294 (discussing the work of Professor Anthony Kronman); *see also* John F. Barry, *The Economics of Outside Information and Rule 10b-5*, 129 U. PA. L. REV. 1307, 1364 (1981) (maintaining that “[a] privilege to exploit information improperly obtained would reduce the incentive to invest in legitimate information production by exacerbating free rider problems and by placing on producers the risk of misappropriation” and that “[l]ess information would be produced, because at least some producers would shift resources from additional production to theft of what others have produced”).

336. Kimberly D. Krawiec & Kathryn Zeiler, *Common-Law Disclosure Duties and the Sin of Omission: Testing the Meta-Theories*, 91 VA. L. REV. 1795, 1862 (2005).

337. *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 771 (2008).

*Pharmaceuticals, Inc. v. Broudo*,<sup>338</sup> a unanimous Court looked to the common law to support its conclusion that private Rule 10b-5 plaintiffs must prove economic loss in order to recover damages.<sup>339</sup> Moreover, in three decisions issued in the 1980s, the Court seemed to view the common law as a foundation for Rule 10b-5 liability that should be expanded to heighten the protection available to those who purchase and sell securities.<sup>340</sup> These somewhat mixed messages suggest that the current Court would view common-law support for a duty to disclose wrongfully obtained information as a necessary, rather than a sufficient, condition for the viability of a “fraud on investors” theory of Rule 10b-5 liability. That is, in addition to having a valid doctrinal basis, for the “fraud on investors” theory to be accepted, the theory must also make sense as a matter of policy.

The government has several strong policy arguments in support of an insider trading theory based on “fraud on investors.” First, the theory avoids the charge of pretext that critics have lodged at *O’Hagan’s* “fraud on the source” misappropriation theory and would likely lodge at a theory of “deceptive acquisition.”<sup>341</sup> Indeed, because the violation at issue involves the deception of the investors on the other side of the securities transaction, the conduct prohibited is precisely the type of conduct that Congress intended Section 10(b) to reach.<sup>342</sup> As the Supreme Court has emphasized, “[d]efrauded investors are among the very individuals Congress sought to protect in the securities laws.”<sup>343</sup>

338. *Dura Pharms., Inc. v. Broudo*, 544 U.S. 336 (2005).

339. *Id.* at 343–44 (stating that “the common law has long insisted that a plaintiff in [an action for deceit] show not only that had he known the truth he would not have acted but also that he suffered actual economic loss”). See generally Jill Fisch, *Cause for Concern: Causation and Federal Securities Fraud*, 94 IOWA L. REV. 811 (2009) (examining common-law principles enumerated in *Dura* and their applicability to federal securities fraud); Robert B. Thompson, *Federal Corporate Law: Torts and Fiduciary Duty*, 31 J. CORP. L. 877, 887 (2006) (discussing the implications of expanding tort law to securities fraud).

340. See *Basic Inc. v. Levinson*, 485 U.S. 224, 244, n.22 (1988) (stating that “[a]ctions under Rule 10b-5 are distinct from common-law deceit and misrepresentation claims . . . and are in part designed to add to the protections provided investors by the common law”); *Herman & MacLean v. Huddleston*, 459 U.S. 375, 389 (1983) (stating that “an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common-law protections by establishing higher standards of conduct in the securities industry”); see also *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985) (stating that the Court has “eschewed rigid common-law barriers in construing the securities laws”). See generally Margaret V. Sachs, *The Relevance of Tort Law Doctrines to Rule 10b-5: Should Careless Plaintiffs Be Denied Recovery?*, 71 CORNELL L. REV. 96 (1985) (examining common-law principles of justifiable reliance in the context of Rule 10b-5 liability).

341. See *supra* note 325.

342. See Nagy, *supra* note 23, at 1300–04 (arguing that the “fraud on investors” approach is better suited toward the policy objectives of Rule 10b-5); see also Langevoort, *supra* note 19, at 883 (noting that the theory keeps the fraud “legitimately within the zone normally associated with Rule 10b-5”).

343. *Huddleston*, 459 U.S. at 390.

Second, because the theory's disclosure duty applies only to wrongfully obtained information, judicial acceptance of the "fraud on investors" theory would not discourage diligent research or other legitimate methods of uncovering material nonpublic information. To be sure, *Dirks*'s "personal benefit" requirement was created in part to preclude interference with the role of securities analysts.<sup>344</sup> But under a "fraud on investors" theory, securities analysts and other market participants could continue to "ferret out and analyze information."<sup>345</sup>

Finally, the "fraud on investors" theory is better aligned with the Court's policy justifications for the federal insider trading prohibition and more accurately describes what courts actually do when they decide insider trading cases. The theory protects "the integrity of the securities markets against abuses by 'outsiders'"<sup>346</sup> and "promote[s] investor confidence."<sup>347</sup> Furthermore, because it applies to all securities transactions based on wrongfully obtained information, the "fraud on investors" theory captures a broader range of conduct than do theories based on either "fraud on the source" or "deception acquisition." In capturing this broader range of conduct, the theory is better aligned with the results in the litigated cases and settled proceedings discussed in Part III.

For all of these reasons, the government has much to gain by advancing a "fraud on investors" theory in insider trading cases that do not fit squarely into *O'Hagan*'s "deception by a fiduciary" paradigm. Although lower courts may be reluctant to reframe insider trading liability along these lines, persistent advocacy by the SEC may serve to overcome such reluctance. Moreover, given the lack of clarity and consistency under current law, the Supreme Court is bound to confront the issue of Rule 10b-5 liability in insider trading cases in the future.

In the context of an insider trading prosecution by the government, the Supreme Court may well be amenable toward accepting a "fraud on investors" theory. Although the Court has been openly hostile to a broad reading of Rule 10b-5 in private securities litigation,<sup>348</sup> it has embraced the

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344. See *supra* text accompanying note 63 (discussing the chilling effect of a broad prohibition and citing *Dirks v. SEC*, 463 U.S. 646, 658 (1982)).

345. *Dirks*, 463 U.S. at 658. Securities analysts and other investment professionals, however, now operate in the wake of Regulation FD, which effectively prohibits public companies and their insiders from selectively disclosing material information that has not been shared with the general public. See 17 C.F.R. § 243.100(a)–(b)(1) (2008).

346. *United States v. O'Hagan*, 521 U.S. 642, 653 (1997) (citation omitted).

347. *Id.* at 658 (emphasizing that "investors likely would hesitate to venture their capital in a market where trading based on misappropriated nonpublic information is unchecked by law").

348. See *Stoneridge Inv. Partners, LLC v. Scientific-Atlanta, Inc.*, 128 S. Ct. 761, 779 (2008) (Stevens, J., dissenting) ("A theme that underlies the Court's analysis is its mistaken hostility towards the § 10(b) private cause of action."); see also Donald C. Langevoort & G. Mitu Gulati, *The Muddled Duty to Disclose Under Rule 10b-5*, 57 VAND. L. REV. 1639, 1642 (2004) (noting

opposite reading when the government has urged the Court to preserve the government's enforcement authority.<sup>349</sup> *O'Hagan* provides a compelling illustration: strong deference to the government's claim of broad enforcement powers under Section 10(b) rings throughout the six-Justice majority opinion.<sup>350</sup> The unanimous opinion in *SEC v. Zandford*<sup>351</sup> reflects similarly strong deference to the SEC's argument that Section 10(b)'s "in connection with" requirement should be read broadly to impose liability against a broker who misappropriated the proceeds from the sale of securities in his clients' account.<sup>352</sup> And while the Court in *Stoneridge* denied the private plaintiffs' claim for recovery, it did so in a way that preserved the government's ability to pursue participants in fraudulent schemes as primary violators of Rule 10b-5.<sup>353</sup> All of this works in favor of judicial recognition of a "fraud on investors" theory of insider trading liability under Rule 10b-5 because, as we have seen, insider trading is an offense pursued primarily by the government—by the SEC in civil enforcement actions or by the DOJ in criminal actions.<sup>354</sup>

To be sure, certain interpretive difficulties attach to a theory of Rule 10b-5 liability premised on the use of wrongfully obtained information in securities transactions. The greatest challenge, of course, would be in defining the scope of the wrongful conduct triggering the disclosure duty. Here, however, courts could seize upon well-recognized categories such as illegal acts (e.g., theft and bribery), breaches of fiduciary duty, breaches of confidentiality agreements, and tortious acts (e.g., deceit, conversion,

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increased "judicial hostility to expansive interpretations of the federal securities laws, especially in the context of private securities litigation and fraud-on-the-market lawsuits").

349. See Stephen M. Bainbridge & G. Mitu Gulati, *How Do Judges Maximize? (The Same Way Everybody Else Does—Boundedly): Rules of Thumb in Securities Fraud Opinions*, 51 EMORY L.J. 83, 139–40 (2002) (observing that since the retirement of Justice Powell, the current Supreme Court lacks an expert in securities law, and may thus be inclined to defer to the government as a recognized specialist); see also Mark J. Loewenstein, *The Supreme Court, Rule 10b-5 and the Federalization of Corporate Law*, 39 IND. L. REV. 17, 19 (2005) (observing that several Supreme Court decisions have "expanded the reach" of Rule 10b-5).

350. See *supra* text accompanying note 104 (quoting Professor Bainbridge's statement that the *O'Hagan* majority "did essentially what the government told it to do").

351. *SEC v. Zandford*, 535 U.S. 813 (2002).

352. *Id.* at 819–20 (stating that the SEC's "interpretation of the ambiguous text of § 10(b), in the context of formal adjudication, is entitled to deference if it is reasonable") (citing *United States v. Mead Corp.*, 533 U.S. 218, 229–30 & n.12 (2001)).

353. *Stoneridge*, 128 S. Ct. at 770 (holding that private plaintiffs cannot establish reliance and thus cannot state a claim under Rule 10b-5 against participants in a scheme to defraud, but observing that "if business operations are used, as alleged here, to affect securities markets, the SEC enforcement power may reach the culpable actors").

354. See *supra* note 118 (discussing civil monetary penalties under Exchange Act Section 21A and criminal penalties under Exchange Act Section 32(a)). Moreover, unlike in most Rule 10b-5 cases where the private right of action is implied, in insider trading cases, Congress has expressly granted the right of action for contemporaneous traders. See *id.* (discussing Exchange Act Section 20A).



trespass, or invasions of privacy). Thus, the theory would extend to securities trading by computer hackers as well as to the person who absconds with a briefcase left unattended in a conference room. The theory would also encompass securities trading by insiders who misuse the corporation's information for personal profit as well as by outsiders who misappropriate the information in breach of a fiduciary duty owed to the source of the information (with or without brazen disclosure). In addition, the theory would extend to securities trading by persons who agree to maintain the confidentiality of information pertaining to a PIPE transaction, to persons who dupe others into revealing confidential information, and to cybersnoops and potentially some eavesdroppers, who violate established norms of privacy to gain their informational advantage.<sup>355</sup>

If the Supreme Court were to embrace a "fraud on investors" theory of insider trading liability, the SEC could also use its rulemaking powers under Section 10(b) to refine the theory's parameters.<sup>356</sup> The SEC could, for instance, promulgate a definition of "wrongful trading" similar to the statutory proposal discussed in the previous section.<sup>357</sup> The notice-and-comment process entailed by such rulemaking would draw upon the collective expertise of securities issuers, market participants, investors, and the securities bar. This public participation would bolster not only the clarity of the "fraud on investors" theory, but also its legitimacy. Thus, a regulatory definition would engender many of the same advantages as a statutory prohibition, but it could be accomplished more easily than legislation amending the Exchange Act.

## V. CONCLUSION

Despite the Supreme Court's insistence that deception by a fiduciary is essential to the Rule 10b-5 insider trading offense, a host of lower courts and the SEC have disregarded this dictate when it forecloses liability against a person who has traded securities based on wrongfully obtained information. Courts and the SEC have also disregarded fiduciary principles when insiders have demonstrated that they are not misusing their corporation's

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355. The possibility of insider trading based on information obtained through eavesdropping brings to mind the facts of *SEC v. Switzer*, 590 F. Supp. 756 (W.D. Okla. 1984). There, the court concluded after an extensive bench trial that then Oklahoma football coach Barry Switzer did not violate Rule 10b-5 by purchasing stock in an acquisition target based on information that he overheard at a high school track meet. *Id.* at 758, 761, 766. Under a "fraud on investors" theory, the result in *Switzer* likely would not change since the pertinent conversation occurred in a public venue where an expectation of privacy would not have been reasonable.

356. SEC rulemaking in this area would be futile absent the Court's recognition of a "fraud on investors" theory of insider trading liability. That is, in the absence of such recognition, an SEC rule prohibiting "wrongful trading" would surely be challenged as inconsistent with the holdings in *Chiarella*, *Dirks*, and *O'Hagan*.

357. See *supra* text accompanying notes 299–300.

information. These recent court decisions, settlements, and SEC rules reflect an evolving consensus that insider trading involves the wrongful use of confidential information. And while this view can be justified by the policy objectives underlying the Supreme Court's decisions, it currently lacks a solid doctrinal foundation. The gradual demise of fiduciary principles indicates an insider trading jurisprudence that is sorely in need of an overhaul—whether by Congress, the SEC, or the federal courts charged with interpreting Rule 10b-5.